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A Primer of United States Tax Considerations for the Foreign Investor

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I. INTRODUCTION

When Congress ordered the Staff of the Joint Committee on Taxation to draft the Tax Reform Act of 1986 (TRA 86),[1] its mandate was presumably to impart fairness and simplicity to a complicated tax regimen. In attempting to accomplish this task, it may be surmized that the drafters of the statute had in mind primarily domestic issues. The impact of the new Internal Revenue Code of 1986 on foreign investors, however, is also significant. The tax environment created by such measures as lower marginal tax rates may well stimulate increased foreign investment and, possibly, a favorable balance of trade, which, in turn, will contribute to the health of the United States domestic economy.

This Article sets out the fundamentals of the income, estate, and gift taxation of nonresident alien individuals and their estates after TRA 86, as modified by the recently introduced Technical Corrections Bill of 1987,[2] and suggests certain planning techniques for the foreign investor.

It is not intended as an exhaustive treatment of the subject, but rather as a point of departure for detailed planning. Additionally, this Article is concerned only with federal income, estate, and gift taxes. The careful tax planner, however, must also consider the applicability of any state and local income, estate, or gift tax implications.

II. THE QUESTION OF RESIDENCE

The taxation of income, estates, and gifts varies considerably depending on whether the taxpayer, decedent, or donor is a citizen or resident of the United States or a nonresident alien. Depending upon an alien's classification, the tax rate, the tax base, and the unified credit will be different. Accordingly, a useful analytical point of departure is a con-

1. Pub. L. No. 99-514, 100 Stat. 2085 (1986).
2. H.R. 2636, 100th Cong., 1st Sess. (1987).

sideration of the definition of a "resident" for income, estate, and gift tax purposes.

A. Income Tax Law Prior to TRA 86

Prior to DEFRA a resident alien was defined as one who was actually present in the United States but who was not "a mere transient or sojourner."[3] A mere "floating intention" to return to his country of origin would not have rendered the alien a nonresident.[4] An alien was generally deemed not to be a resident if his visit to the United States was "for a definite purpose which in its nature may be promptly accomplished" or was "limited to a definite period by the immigration laws."[5]

Prior law contained a presumption that an alien was a nonresident.[6] This presumption could be rebutted if the alien either filed a declaration of intent to become a United States citizen, filed a Form 1078 claiming residency, indicated through acts and statements a definite intention of becoming a resident, or resided in the United States for at least one year.[7] In determining whether an alien satisfied these factual tests for becoming a resident, the courts resorted to such detailed findings of facts[8] as permanence of place of residence,[9] place of employment or business activities,[10] place of filing of previous tax returns,[11] ownership and registration of motor vehicles or driver's license,[12] and church and fraternal affiliations.[13]

Though not determinative for federal purposes, state statutory presumptions can be enlightening. In California, an individual is presumed to be a California resident if he or she is present in the state for more than nine months in any one taxable year.[14] The presumption may be

3. Treas. Reg. § 1.871-2(b) (1986).

4. *Id.*

5. *Id.*

6. Treas. Reg. § 1.871-4(b) (1986).

7. Treas. Reg. § 1.871-4(c) (1986).

8. Tongsun Park v. Commissioner, 79 T.C. 252 (1982); Adams v. Commissioner, 46 T.C. 352 (1966), *acq.*, 1967-2 C.B. 1. The findings of fact in the *Park* case are very detailed. It is an example of the detailed analysis undertaken by the courts regarding the question of residency.

9. Sutton v. United States, 79-1 U.S. Tax Cas. (CCH) ¶ 9293 (1979); Marsh v. Commissioner, 68 T.C. 68 (1977); Ermogeni v. Commissioner, 35 T.C.M. (CCH) 870 (1976); Jellinek v. Commissioner, 36 T.C. 826 (1961), *acq.*, 1964-1 C.B. 4.

10. Brittingham v. Commissioner, 66 T.C. 373 (1976); Rev. Rul. 73-578, 1973-2 C.B. 39.

11. Beisinger v. Commissioner, 27 T.C.M. (CCH) 725 (1968); Swenson v. Thomas, 164 F.2d 783 (5th Cir. 1947).

12. Escobar v. Commissioner, 68 T.C. 304 (1977).

13. Brittingham v. Commissioner, 66 T.C. at 373.

14. CAL. REV. & TAX. CODE § 17016 (West 1983).

rebutted by a showing of a closer connection with another jurisdiction.[15] A resident is defined as every individual in the state for other than a temporary or transitory purpose, and every domiciliary outside the state for a temporary or transitory purpose.[16]

In New York, one is subject to state taxes if: (1) he or she is not domiciled in the state, but maintains a permanent place of abode in the state and spends more than 183 days in the state during the taxable year; or (2) he or she is domiciled in the state, unless he or she (a) maintains no permanent place of abode in the state, (b) maintains a permanent place of abode elsewhere during year, and (c) spends no more than thirty days of the year in the state.[17] In computing days spent in New York, any part of a calendar day constitutes a day spent in the state, unless it is solely for boarding transportation or passing through the state to a destination outside of the state.[18]

B. Income Tax Law Since TRA 86

Section 7701(b)(1)(A), added by the Deficit Reduction Act of 1984 (DEFRA),[19] defines a resident alien for income tax purposes as an individual who meets either the lawful permanent resident test or the substantial presence test.[20] To meet the lawful permanent resident test, an individual must hold a green card which has not been revoked or determined to be abandoned.[21] To meet the substantial presence test, an individual must be present in the United States for at least thirty-one days during the calendar year, and the sum of the following must equal or exceed 183: (a) the days present during the current year; (b) one-third times the days present during the preceding year; and (c) one-sixth times the days present during the second preceding year.[22] The substantial presence test will not be met where the alien is present less than 183 days in the current year, has a closer connection to a foreign country than to the United States, and has a tax home in the foreign country.[23] This exception does not apply where an alien has an application for adjustment of status pending or has taken other other steps to apply for status

15. *Id.*
16. CAL. ADMIN. CODE tit. 18, § 17014, 17016 (1983).
17. N.Y. TAX LAW § 605 (McKinney 1975).
18. *Id.*
19. Pub. L. No. 98-369 § 138, 98 Stat. 494, 672-77 (1984).
20. I.R.C. § 7701(b)(1)(A) (1986).
21. I.R.C. § 7701(b)(5) (1986).
22. I.R.C. § 7701(b)(3)(A) (1986).
23. I.R.C. § 7701(b)(3)(B) (1986).

as a lawful permanent resident.[24]

For purposes of the substantial presence test, a person is deemed not to be present in the United States if he or she is a member of certain exempt classes. These classes are: (1) diplomatic or other foreign government-related individuals and their immediate families;[25] (2) teachers or trainees;[26] (3) students;[27] (4) commuters from Canada and Mexico;[28] (5) persons in transit between two foreign points who are in the United States for less than twenty-four hours;[29] (6) persons unable to leave the United States because of a medical condition which arose while they were present in the United States;[30] and (7) professional athletes present in the United States to compete in certain charitable sports events.[31]

Under section 7701(b)(4), a nonresident alien may make a special first year election to become a resident in the year before he or she will become a resident under section 7701(b)(1)(A). This election may be made if the nonresident alien is in the United States for at least thirty-one days during the election year, and for seventy-five percent of the days between the beginning of that period and the end of the taxable year.[32]

Other special rules exist for the first and last years of consideration as a resident. An alien individual who was not a resident for the previous year becomes a resident in the current year only for the period of the current year commencing on the "residency starting date."[33] For the last year of residency, an individual is not treated as a resident for the period of the calendar year after the last day the individual was present in the United States or was a lawful permanent resident if during that period the individual has a closer connection to a country outside the United States, and if the individual is not a United States resident at any time during the next calendar year.[34] For these purposes, "nominal presence"

24. I.R.C. § 7701(b)(3)(C) (1986). This provision, however, insures the continuing applicability of the criteria developed by the cases cited in notes 8-13, *supra*.

25. I.R.C. § 7701(b)(5)(A)(i) (1986).

26. I.R.C. § 7701(b)(5)(A)(ii) (1986). This is generally a four-year exemption.

27. I.R.C. § 7701(b)(5)(A)(iii) (1986). This is generally a five-year exemption.

28. I.R.C. § 7701(b)(7)(B) (1986).

29. I.R.C. § 7701(b)(7)(C) (1986).

30. I.R.C. § 7701(b)(3)(D)(ii) (1986).

31. I.R.C. § 7701(b)(5)(A)(iv) (1986).

32. I.R.C. § 7701(b)(4)(A)(iv) (1986).

33. I.R.C. § 7701(b)(2)(A) (1986). The "residency starting date" is defined as either: (1) the first day on which an individual is present in the United States as a lawful permanent resident for individuals meeting the lawful permanent resident test, (2) the first day on which the individual is present in the United States for individuals meeting the substantial presence test, or (3) if residency occurs because a first year election was made, the first day on which the individual is treated as a resident under the first year election rules. *Id.*

34. I.R.C. § 7701(b)(2)(B) (1986).

in the United States, which is defined as no more than ten days, is disregarded.[35]

An individual may also be taxed as a resident if he or she meets the requirements of section 7701(b)(10). If an individual was a resident for a period of at least three consecutive calendar years, then ceases to be a resident, but thereafter resumes residency within three years of the initial residency period, the individual will be liable for tax with respect to the intervening years as set forth in section 877(b).[36]

The above rules, however, do not override treaty definitions of residency. Thus, an individual may be taxed under the laws of a treaty partner with respect to treaty income by virtue of a treaty definition of residency, while at the same time being a resident for United States income tax purposes with regard to nontreaty income.[37]

C. Estate Tax

The determination of residence for estate tax purposes is different than for income tax purposes.[38] The Treasury Regulations define a "resident" decedent as a United States domiciliary "with no definite, present intention of later removing therefrom."[39] The regulation further states that "[r]esidence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal."[40]

D. Gift Tax

A "resident" for gift tax purposes is defined as an individual who is a United States domiciliary at the time of the gift.[41] This definition is very similar to the definition for estate tax purposes.[42] A nonresident for gift tax purposes is defined as an individual who is not a United States

35. I.R.C. § 7701(b)(2)(C) (1986).

36. I.R.C. § 7701(b)(10) (1986). This is so unless the tax determined in accordance with section 871 is higher. *Id.*

37. *See infra* note 48.

38. Estate of Nienhuys v. Commissioner, 17 T.C. 1149 (1952). *See also* I.R.C. § 7701(b) (1986); Rev. Rul. 74-364, 1974-2 C.B. 321.

39. Treas. Reg. § 20.0-1(b) (1986).

40. *Id.* Intent alone is insufficient to make one a domiciliary. Rather, intent must be accompanied by an affirmative act. Rev. Rul. 58-70, 1958-1 C.B. 341. For factors important in determining residence, see generally Estate of Bloch-Sulzberger v. Commissioner, 6 T.C.M. 1201 (1947); Fifth Avenue Bank of New York, Executor v. Commissioner, 36 B.T.A. 534 (1937); Farmers' Loan & Trust Co. v. United States, 60 F.2d 618 (S.D.N.Y. 1932). *See also supra* notes 8-13.

41. Treas. Reg. § 25.2501-1(b) (1986).

42. *See supra* note 39.

domiciliary at the time of the gift.[43] Because the manner of defining residence is similar in both the estate and gift tax areas, it appears that a resident for gift tax purposes may not be treated the same as a resident for income tax purposes.[44]

E. Residents of Possessions

I.R.C. sections 2208 and 2209 relating to estate tax, and sections 2501(b) and 2501(c) relating to gift tax, provide special rules for "residents of possessions." Although such residents are generally treated as nonresident aliens with regard to the United States, they receive somewhat different tax treatment than nonresident aliens. These sections and issues are worthy of the foreign investor's attention, but will not be addressed in this article.

F. Treaties

Tax treaties may override the Internal Revenue Code for purposes of defining a resident. For example, Article I of the United States-Netherlands Estate Tax Treaty[45] covers estates of former United States citizens, and thus overrides I.R.C. section 2107. Section 2107 includes in the estates of former citizens of the United States who expatriated for tax avoidance purposes, United States situs property plus stock of any corporation which would have been a "controlled foreign corporation"[46] if the decedent had been a United States citizen.[47] Furthermore, the DEFRA Conference Committee Report regarding section 7701(b) expressly states that the DEFRA conference agreement was not intended to override the treaty obligations of the United States.[48] An increasing number of treaties, however, contain limitation-of-benefits clauses which restrict treaty benefits to entities owned by a certain percentage of residents of the treaty country or of the United States.[49] These provisions, arguably, prevent treaty shopping.

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43. *Id.* Treas. Reg. § 25.2501-1(b) (1986). For these purposes, the definition of United States does not include United States possessions. I.R.C. § 7701(a)(9) (1986).

44. *Cf. Estate of Nienhuys*, 17 T.C. 1149 (1952) (cited for the proposition that residence for gift tax purposes is not the same as residence for income tax purposes).

45. Convention for the Avoidance of Double Taxation, July 15, 1969, United States-Netherlands, art. 1, 22 U.S.T. 247, 249, T.I.A.S. No. 7061.

46. *See* I.R.C. § 957 (1986).

47. I.R.C. § 2107 (1986).

48. H.R. REP. No. 861, 98th Cong., 2d Sess. 967 (1984).

49. *See* Freud, *Treaty Shopping and the 1981 United States Treasury Model Income Tax Treaty*, 6 HAST. INT'L & COMP. L. REV. 627 (1984).

III. TAX RATES

A. Income Tax

1. Citizens and Residents

For 1986, the tax rates are progressive, ranging from eleven percent on taxable income in excess of $2,300 for an unmarried taxpayer to fifty percent on taxable income in excess of $81,800.[50]

For 1987, there will be transitional rate tables, as follows:[51]

Rate	Single Taxpayers	Married Taxpayers Filing Jointly
11%	0 - $ 1,800	0 - $ 3,000
15%	$ 1,800 - $16,800	$ 3,000 - $28,000
28%	$16,800 - $27,000	$28,000 - $45,000
35%	$27,000 - $54,000	$45,000 - $90,000
38.5%	over $54,000	over $90,000

For 1988, four different tax rates will apply to taxable income, as follows:[52]

Rate	Single Taxpayers	Married Taxpayers Filing Jointly
15%	0 - $17,850	0 - $ 29,750
28%	$17,850 - $43,150	$29,750 - $ 71,900
33%	$43,150 - $89,560	$71,900 - $149,250
28%	over $89,560	over $149,250

The upper limit of the thirty-three percent bracket ($89,560 for single taxpayers) increases an additional $10,920 for each personal exemption claimed by the taxpayer on returns after 1987.[53] This increase rises to $11,200 in 1989, and is adjusted for inflation thereafter.[54]

Beginning in 1989, individual tax rates will again be adjusted annually for inflation, in accordance with the Consumer Price Index.[55]

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50. I.R.C. § 1(c) (1985).
51. I.R.C. § 1(h) (1986).
52. I.R.C. § 1(a), (c), (g) (1986).
53. I.R.C. §§ 1(g)(2)(B), 151(d)(1), (3) (1986).
54. I.R.C. § 1(f) (1986).
55. *Id.*

2. Nonresident Aliens

United States source income not effectively connected with the conduct of a trade or business in the United States[56] is taxed at a flat thirty percent rate on gross income, unless otherwise varied by treaty.[57] If a nonresident alien is either present in the United States for more than 183 days in the taxable year, or is engaged in the conduct of a trade or business in the United States, nonreal estate capital gains will also be subject to a thirty percent tax rate on the gross amount of the gain, unless varied by treaty.[58] If the nonresident alien does not fall within either of the foregoing classes, nonreal estate capital gains are not taxed.[59]

Gain from the sale or other disposition of a United States real property interest (USRPI)[60] is subject to tax as if that gain were effectively connected with the conduct of a trade or business within the United States.[61] The gain is treated as being from sources within the United States.[62]

For 1986, the character of the foreign investor's gain determines whether graduated ordinary income or capital gains rates apply. Because TRA 86 dispenses with a special rate for capital gains,[63] post-1986 capital gains will be taxed at ordinary income rates. TRA 86, however, does not dispense with the capital loss rules.[64] Therefore, the character of the gain remains important for short and long term capital loss offset purposes.

TRA 86 also changes the alternative minimum tax rate on nonresident aliens with respect to the disposition of a USRPI. The tax rate is now twenty-one percent of (1) the lesser of the nonresident alien individual's alternative minimum taxable income under section 55(b)(2) for the taxable year, or (2) his United States real property gain for the taxable year.[65] As a result of DEFRA, the tax is withheld.[66]

In addition, TRA 86 added section 884, which imposes a thirty per-

56. *See infra* notes 147-52 and accompanying text.

57. I.R.C. § 871(a)(1) (1986).

58. I.R.C. § 871(a)(2) (1986).

59. *Id.*

60. See *infra* notes 153-63 and accompanying text for a definition of a United States real property interest.

61. I.R.C. § 897(a)(1) (1986).

62. I.R.C. § 861(a)(5) (1986).

63. I.R.C. § 1202, which granted a sixty percent exclusion of the capital gain from adjusted gross income, was repealed. Pub. L. No. 99-514, § 301(a) 100 Stat. 2085 (1986).

64. I.R.C. §§ 1211, 1212 (1986).

65. I.R.C. § 897(a)(2) (1986).

66. *See infra* notes 361-434 and accompanying text.

cent branch profits tax on the "dividend equivalent amount"[67] generated by a foreign corporation engaged or deemed to be engaged in a trade or business in the United States for the taxable year.[68] To the extent that there is allocated to a branch an interest deduction in excess of interest it actually paid, the excess is treated as interest paid by a subsidiary and is subject to a thirty percent tax.[69]

Income effectively connected with the conduct of a trade or business in the United States is subject to the same graduated rates as those which apply to United States citizens and residents.[70] This tax is imposed in addition to the taxes imposed by sections 882 or 897 on foreign corporations.[71] No foreign tax credit under section 906 is allowed for the section 884 tax.[72]

A nonresident alien who has not established a taxable year for any prior period will be treated as having a calendar taxable year.[73] Residence for fiscal year taxpayers will be determined on a calendar year.[74]

B. Estate and Gift Tax

1. Unified Rate

The Tax Reform Act of 1976[75] created a unified tax rate and a unified credit for lifetime transfers (taxable gifts)[76] and death transfers (taxable estates).[77] Essentially, all transfers of property subject to either the gift or the estate tax are combined. The estate tax rate is applied to the total of the subject transfers, and the unified credit is then subtracted from the result.[78] The foreign investor should be careful to note, however, that the rate and the credit will vary depending on whether the decedent or transferor is a citizen or resident or a nonresident alien.[79]

2. Citizens and Residents

The estate and gift tax rates are progressive, ranging from eighteen

67. *See* I.R.C. § 884(a) (1986).
68. I.R.C. § 884 (1986).
69. Treas. Reg. § 1.882-5 (1986).
70. I.R.C. §§ 871(b), 882(a) (1986).
71. I.R.C. §§ 884(a), 897(a) (1986).
72. I.R.C. § 906(b)(6) (1986).
73. I.R.C. § 7701(b)(9)(A) (1986).
74. I.R.C. § 7701(b)(9)(B) (1986).
75. Pub. L. No. 94-455, 90 Stat. 1846 (1976).
76. I.R.C. §§ 2001, 2010 (1986).
77. I.R.C. §§ 2502, 2505 (1986).
78. I.R.C. § 2001(b) (1986).
79. I.R.C. §§ 2001, 2010, 2101(d), 2102(c) (1986).

percent on the first $10,000 of taxable transfers, to fifty percent on the excess over $2.5 million of taxable transfers.[80] Taxable transfers are determined cumulatively during the taxpayer's lifetime and at death.[81] There is a unified credit applied to any estate and gift tax equal to $47,000 for post-1980 and pre-1982 lifetime or death, transfers subject to a phase-in provision.[82] The phase-in of the credit as originally contemplated by the Economic Recovery Tax Act of 1981 (ERTA)[83] was amended by DEFRA, with the result that by 1987, the unified credit gradually increased as follows:

Year	Tax-Free Credit	Threshold
1982	$ 62,800	$225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 and later	192,800	600,000

3. Nonresident Aliens

Lifetime transfers by nonresident aliens are subject to the same rate of tax which applies to citizens and residents.[84] Death transfers, however, are subject to a substantially lower progressive rate, ranging from six percent on the first $100,000 of taxable transfers, to thirty percent on the excess over $2 million of taxable transfers.[85] As is the case with citizens and residents, taxable transfers are determined cumulatively during the taxpayer's lifetime and at death.[86] Unlike citizens and residents, however, nonresident aliens are not eligible for the unified gift tax credit.[87] Instead, aliens are only eligible for a nonrefundable estate tax credit of $3,600.[88] Nonresident aliens are also ineligible for the unlimited marital deduction.[89]

80. I.R.C. § 2001(c)(1) (1986). This rate ranges to 55% on estates over $3,000,000 for 1984-87. I.R.C. § 2001(c)(2)(D) (1986).
81. I.R.C. § 2001(b) (1986).
82. I.R.C. §§ 2010, 2505 (1986).
83. Pub. L. No. 97-34, 95 Stat. 172, 299 (1981).
84. I.R.C. § 2501(a)(1) (1986).
85. I.R.C. § 2101(d) (1986).
86. I.R.C. § 2101(b) (1986).
87. I.R.C. § 2505(a)(2) (1986).
88. I.R.C. § 2102(c)(1) (1986).
89. I.R.C. §§ 2106, 2056 (1986).

IV. TAX BASE

A. Generally

For citizens and residents, the income, estate, and gift tax bases include all property of whatever kind and wherever situated.[90] For nonresident aliens, the income tax base is governed by source rules,[91] and by whether such income is deemed effectively connected with the conduct of a trade or business in the United States.[92] Similarly, the estate and gift tax base is governed by situs rules,[93] unless otherwise modified by an applicable estate and gift tax treaty.[94]

B. Income Tax

1. Source Rules

The Code lists items of gross income deemed to be income from sources within the United States[95] and those deemed to be from sources outside[96] or partly outside the United States.[97]

a. *Interest*

Interest from the United States and United States obligors generally constitutes United States source income.[98] There are, however, many exceptions to this general rule:

(1) interest on bank or savings and loan accounts and on agreements with insurance companies which are not effectively connected with the conduct of a trade or business in the United States.[99] This exception also applies to nongrantor United States conduit trusts which are established for the benefit of nonresident aliens and whose corpus consists of United States bank deposits;[100]

(2) interest from obligations of a resident alien individual or do-

90. I.R.C. §§ 61, 2001, 2501; Treas. Reg. §§ 1.61-1(a), 20.0-2(b)(2), 25.2501-1(a)(1) (1986).

91. *See generally* I.R.C. §§ 861-897 (1986) (defining sources of income of nonresident aliens within the United States).

92. I.R.C. §§ 864(b), 864(c) (1986). These rules are subject to modification by an applicable income tax treaty.

93. I.R.C. §§ 2103, 2511(a) (1986).

94. *See* Treas. Reg. § 20.2104-1(c) (1986).

95. I.R.C. § 861 (1986).

96. I.R.C. § 862 (1986).

97. I.R.C. § 863 (1986).

98. I.R.C. § 861(a)(1) (1986).

99. I.R.C. § 871(i)(2)(A) (1986).

100. Isidro Martin-Montis Trust v. Commissioner, 75 T.C. 381 (1980). *See also* Rev. Rul. 81-244, 1981-2 C.B. 151.

mestic corporation whose gross income for the three years preceding the payment of interest consisted of at least eighty percent "active foreign business income."[101] Where a "related person"[102] receives interest from a payor meeting the eighty percent active foreign business income requirement, the exclusion from United States source income for the payor's non-United States source income is only ratable.[103] Prior to TRA 86, less than twenty percent of the payor's gross income within the three preceding taxable years had to be derived from United States sources in order to qualify for the source exclusion;[104]

(3) pre-TRA 86 interest from obligations of non-United States persons, whose gross income for the three years preceding the payment of interest is less than fifty percent effectively connected with the conduct of a trade or business in the United States.[105] If more than fifty percent is effectively connected, there is ratable inclusion in United States source income;[106]

(4) interest from deposits with a foreign branch of a United States banking corporation or partnership if engaged in commercial banking;[107]

(5) interest derived by a foreign central bank of issue on bankers' acceptances;[108]

(6) portfolio interest,[109] which includes interest payable to a nonresident alien who owns less than ten percent of all classes of stock of a corporate obligor[110] or less than ten percent of the capital or profits interest in a partnership obligor,[111] and interest payable with respect to certain registered or unregistered obligations issued after July 18, 1984.[112]

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101. I.R.C. § 861(a)(1)(A) (1986). "Active foreign business income" is defined as gross income derived from sources outside the United States and attributable to the active conduct of a trade or business outside the United States by the payor or its 50%-or-more-owned subsidiaries. I.R.C. § 861(c)(1)(B) (1986).

102. A "related person" for purposes of this exception is defined in I.R.C. § 861(c)(2)(B) (1986).

103. I.R.C. § 861(c)(2)(A) (1986). The exclusion in these cases, is equal to the percentage of the interest which the payor's non-United States gross income bears to his total gross income for the three taxable years preceeding the year of the interest payment. *Id.*

104. I.R.C. § 861(a)(1)(B) (1985).

105. I.R.C. § 861(a)(1)(C) (1985).

106. I.R.C. § 861(a)(1)(D) (1985). The inclusion ratio is the proportion of the payor's United States effectively connected income to its gross income from all sources for the three taxable years preceeding the year of payment. *Id.*

107. I.R.C. § 861(a)(1)(B) (1986).

108. I.R.C. § 871(i)(2)(C) (1986).

109. Portfolio interest is defined in I.R.C. § 871(h)(2) (1986).

110. The attribution rules of § 318(a) apply, but with modifications. I.R.C. § 871(h)(3)(C) (1986).

111. I.R.C. § 871(h)(3)(B) (1986).

112. I.R.C. § 871(h)(2) (1986). If the obligations are in registered form, the "withholding

As a side note, section 127(g)(3) of DEFRA granted amnesty for interest paid to a controlled foreign corporation[113] on a United States finance affiliate obligation issued before June 22, 1984, the date of conference action.

b. *Dividends*

Dividends also constitute United States source income to the extent that they are:

(1) from a domestic corporation, other than one that has made an election with regard to the possessions credit under section 936, and more than eighty percent of whose gross income for the three years preceding the declaration of the dividend is active foreign business income.[114] There is ratable inclusion of only the portion of the dividend that represents the portion of the payor corporation's gross income, which is derived from United States sources.[115] Prior to TRA 86, a dividend was deemed non-United States source income if less than twenty percent of the payor corporation's gross income for the preceding three years was from United States sources;[116]

(2) from a foreign corporation, unless less than twenty-five percent of its gross income for the three years preceding the declaration of the dividend was effectively connected (or treated as effectively connected other than for branch profits tax purposes) with the conduct of a trade or business in the United States.[117] If more than twenty-five percent is effectively connected (or treated as effectively connected other than for branch profits tax purposes), there is ratable inclusion, with special treatment for inter-corporate dividends.[118] Prior to TRA 86, the threshold was fifty percent;[119]

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agent," *see infra* notes 282-96 and accompanying text, must have received a statement, either from the beneficial owner of the obligation or a securities clearing organization or other financial organization which regularly holds customers' securities, that the beneficial owner of the obligation is not a United States person. I.R.C. § 871(h)(2)(B) (1986). If the obligations are not in registered form, there must be arrangements reasonably designed to assure that the obligation will be sold to non-United States persons, *cf.* Treas. Reg. § 1.163-5(c)(2)(i) (1986); interest must be paid outside the United States and its possessions, Treas. Reg. § 1.163-5(c)(2)(v) (1986); and the obligation and any detachable coupon must state on its face that a United States person who holds the obligation will be subject to limitations under the United States income tax laws, Treas. Reg. § 1.163-5(c)(1)(ii)(B) (1986).

113. *See* I.R.C. § 957(a) (1986).
114. I.R.C. § 871(i)(2)(B) (1986).
115. I.R.C. § 871(i)(2)(B) (1986).
116. I.R.C. § 861(a)(2)(A) (1985).
117. I.R.C. § 861(a)(2)(B) (1986).
118. *Id.*
119. I.R.C. § 861(a)(2)(b) (1985).

(3) from a foreign corporation to the extent required by section 243(d) relating to certain dividends from foreign corporations.[120] TRA 86 limits the post-1986 intercorporate dividend deduction for dividends from foreign corporations to United States corporate shareholders who hold at least ten percent of the foreign corporation;[121]

(4) from a Domestic International Sales Corporation (DISC), or former DISC, except to the extent prescribed by the Secretary's regulations regarding qualified export receipts.[122]

c. *Other Income*

Personal service compensation is generally deemed to be United States source income. Such compensation however will not be United States source income if: (1) the labor or services were performed by a nonresident alien temporarily present in the United States for no more than 90 days; (2) such compensation does not exceed $3,000; and (3) the services performed are either (a) for a nonresident alien, foreign partnership, or foreign corporation not effectively connected with the conduct of a trade or business in the United States, or (b) for a resident, domestic partnership or corporation, provided that the services are performed for an office located in a foreign country or United States possession.[123]

Rentals and royalties from property used within the United States are United States source income,[124] as is gain from the sale or other disposition of a USRPI as defined in section 897(c).[125]

Pre-1987 sales or exchanges of personal property give rise to United States source income if bought and sold within the United States.[126] TRA 86 retains the foregoing rule for post-1986 sales of inventory property,[127] but changes the general rule for sourcing personal property gains and losses to a "residence-of-the-seller" test, subject to certain exceptions.[128]

120. I.R.C. § 861(a)(2)(C) (1986).
121. I.R.C. § 245(a) (1986).
122. I.R.C. § 861(a)(2)(D) (1986).
123. I.R.C. § 861(a)(3) (1986).
124. I.R.C. § 861(a)(4) (1986).
125. I.R.C. § 861(a)(5) (1986). *See also infra* notes 153-73 and accompanying text.
126. I.R.C. § 861(a)(6) (1985).
127. I.R.C. § 861(a)(6) (1986).
128. I.R.C. § 865 (1986). For example, gain from the sale of depreciable personal property not in excess of depreciation adjustments is allocated within and without the United States proportionally to the United States and non-United States depreciation adjustments. I.R.C. § 865(c)(1) (1986). Gain in excess of depreciation adjustments is treated as gain from inventory property. I.R.C. § 865(c)(2) (1986). Where gain from the use of an intangible is contingent on its productivity, use, or disposition, the gain is treated as a royalty. I.R.C. § 865(d)(1)

Other items of United States source income include underwriting income from the insurance of United States risks,[129] social security benefits received after 1983 in tax years ending after 1983,[130] and distributions to foreign partners of a partnership effectively connected or treated as effectively connected with the conduct of a trade or business in the United States.[131]

Tax on all the foregoing items,[132] except for real property gains, is withheld at the source if the nonresident alien is not engaged in the conduct of a trade or business in the United States, or is not present for more than 183 days during the taxable year.[133] Gain from the sale or other disposition of a USRPI is always deemed effectively connected with the conduct of a trade or business in the United States, and is thus included in the United States income tax base of the nonresident alien.[134] Therefore, such gain is never subject to the thirty percent source withholding tax.[135] As a result of DEFRA, however, another regimen of withholding applies to such gains.[136] TRA 86 adds section 1446, which imposes a twenty percent withholding tax on amounts distributed after 1987 to foreign partners from a partnership that has gain, income, or loss which is actually or deemed to be effectively connected with the conduct of a trade or business within the United States.[137] Finally, personal service

(1986). Otherwise, the general rule applies, with goodwill, however, being sourced in the country where it was generated. I.R.C. § 865(d)(3) (1986). Income from the sale of personal property from a fixed place of business is sourced where the fixed place of business is located, within the principles of section 864(c)(5). I.R.C. § 865(e)(3) (1986). A United States resident, who sells stock of a foreign affiliate engaged in the active conduct of a trade or business more than 50% of whose income within the previous three years is derived in the country of sale, receives non-United States source income from the sale. I.R.C. § 865(f) (1986). Section 112(d)(4) of the Technical Corrections Act of 1987 amends I.R.C. § 865(f) to assure this result whether the parent or subsidiary is engaged in an active trade or business in the country where the sale occurs. H.R. 2636, 100th Cong., 1st Sess. § 112(d)(4) (1987).

129. I.R.C. § 861(a)(7) (1986). This section extends to foreign insurance corporations which insure United States risks and which are at least 25%-owned by United States persons, who are required, by new section 953(c), for taxable years beginning after December 31, 1986, to pay current tax on the earnings of such foreign insurance corporations, whatever the degree of stock ownership by the United States person. This essentially eliminates the tax advantages associated with mutually-owned offshore insurance companies.

130. I.R.C. § 861(a)(8) (1986).

131. I.R.C. § 875 (1986).

132. *See supra* notes 98-131 and accompanying text.

133. I.R.C. § 1441(a) (1986). *See also infra* notes 263-360 and accompanying text.

134. I.R.C. §§ 861(a)(5), 897(a)(1) (1986).

135. I.R.C. § 1441(c)(1) (1986).

136. *See infra* notes 361-443 and accompanying text.

137. *See infra* notes 444-50 and accompanying text.

income is always subject to withholding. All of the foregoing withholding rules are subject to variation by treaty.

In addition to being taxed on items of United States source income, as discussed above, a nonresident alien or foreign corporation is subject to taxation at graduated tax rates applicable to citizens on worldwide effectively connected income from the conduct of a trade or business.[138] Accordingly, it is necessary to analyze the concepts of "engaged in trade or business" and "effectively connected income."

2. Engaged in Trade or Business

There is no Code provision defining the phrase "engaged in trade or business."[139] The cases generally focus on the place where decisions are made and where operating control of the tax entity is maintained.[140] Thus, whether a nonresident alien is considered for tax purposes to be engaged in a United States trade or business is a question of fact to be decided in each case, dependent upon the nature and extent of his or her economic contacts with the United States.[141]

Nonetheless, section 864 does offer safe harbors with relation to specific activities. For example, the Code specifically states that "trading in stocks or securities through a resident broker, commission agent, custodian, or other independent agent" will not be considered a trade or business within the United States.[142] Even if such transactions are made by nonresident aliens themselves while personally present in the United States, or through any agent, custodian, or broker, they will not constitute a United States trade or business.[143]

A foreign person who is a member of a domestic or foreign partnership trading in securities for its own account will not be considered engaged in the conduct of a trade or business in the United States, unless the partnership is also a dealer, or its principal business is trading in securities for its own account, and its principal place of business is

138. I.R.C. §§ 871(b), 882(a) (1986).

139. *See, e.g.*, I.R.C. § 864(b) (1986).

140. *See* Garelik, *What Constitutes Doing Business Within the United States by a Non-Resident Alien Individual or a Foreign Corporation*, 18 TAX. L. REV. 423 (1963).

141. Treas. Reg. § 1.864-2(e) (1986).

142. I.R.C. § 864(b)(2)(A)(i) (1986); Treas. Reg. § 1.864-2(c)(1) (1986).

143. I.R.C. § 864(b)(2)(A)(i) (1986); Treas. Reg. § 1.864-2(c)(2)(i) (1986). Securities involved in such transactions may include debt instruments, such as money market instruments. The volume of the transactions is not determinative of whether the nonresident alien is engaged in a trade or business. So long as the person effects securities transactions for his own account and risk, activities closely related thereto, including obtaining credit for such purposes, are also not considered engaging in a trade or business. Treas. Reg. § 1.864-2(c)(2)(i) (1986).

within the United States.[144] If, however, five or fewer partners own, directly or indirectly, more than fifty percent of the partnership's capital or profits interest at any time during the last half of its taxable year, the partnership will not be treated as being engaged in the conduct of a trade or business in the United States even if the foregoing conditions are satisfied.[145] If a foreign person trades for the account of another, the foreign person will not be considered engaged in a trade or business in the United States if the foreign person has no office or other fixed place of business in the United States through which, or by the discretion of which, such trades are made.[146]

3. Effectively Connected Income

Whether income from sources within the United States of the type specified in section 871(a)(1) is effectively connected with the conduct of a trade or business in the United States depends on whether such income is derived from assets used or held for use in the conduct of a trade or business (the "asset-use" test),[147] or whether the activities of such trade or business were a material factor in the generation of such income (the "material-factor" test).[148]

The "asset-use" test is met if the assets are: (1) held to promote the present conduct of the trade or business; (2) held in the ordinary course of the trade or business; or (3) otherwise held in a direct relationship to the business.[149] There is a presumption of direct relationship where: (1) the asset is acquired with funds from the trade or business; (2) the income from the asset is reinvested; and (3) United States personnel actively involved in the trade or business exercise significant management and control over investment of the asset.[150]

The "material-factor" test is satisfied where an asset is a material factor in the production of income. Investment portfolio management activities, however, will not be treated as activities conducted in the United States unless the maintainance of the investments constitutes the

144. Treas. Reg. § 1.864-2(c)(2)(ii) (1986).

145. *Id.*

146. I.R.C. § 864(b)(2)(C) (1986); Treas. Reg. § 1.864-2(c)(1) (1986).

147. I.R.C. § 864(c)(2)(A) (1986).

148. I.R.C. § 864(c)(2)(B) (1986).

149. Treas. Reg. § 1.864-4(c)(2)(ii) (1986). The relationship described in the third part of the test exists if the asset is presently needed in the taxpayer's business, *i.e.*, if it is retained to meet the business' operating expenses, but not for anticipated growth. Treas. Reg. § 1.864-4(c)(2)(iii) (1986).

150. Treas. Reg. § 1.864-4(c)(2)(iii)(b) (1986).

principal activity of that trade or business.[151]

The foreign investor should be aware that even if certain income is considered non-United States source income, such income may still be effectively connected with the conduct of a trade or business in the United States, and therefore may be taxable to the nonresident alien.[152]

4. United States Real Property Interests

A United States real property interest (USRPI) is defined as: (1) an interest in real property (other than an interest solely as a creditor) located in the United States or (for dispositions after June 18, 1980) the Virgin Islands;[153] (2) personal property associated with the use of real property;[154] and (3) any interest in a *domestic* corporation, other than an interest held solely as a creditor, unless the taxpayer establishes that during the shorter of the period after June 18, 1980 during which the taxpayer held such interest, or the five-year period ending on the date of disposition of the foreign investor's interest, the domestic corporation was not a "United States real property holding corporation" (USRPHC).[155]

A USRPHC includes any corporation, whether domestic or foreign, having USRPIs with a fair market value equal to or in excess of fifty percent of the fair market value of the corporation's worldwide real property interests, plus its trade or business assets.[156] In this context, trade or business assets includes cash, stock, or securities so long as they are used or held for use in a trade or business.[157] An exception to this rule exists

151. Treas. Reg. § 1.864-4(c)(3)(i) (1986).

152. I.R.C. §§ 864(c)(4)(B), (C), 897(a)(1) (1986).

153. I.R.C. § 897(c)(1)(A)(i) (1986); Treas. Reg. § 1.897-1(c)(i) (1986). Such an interest includes a fee ownership or a leasehold interest in real property and options to acquire the same. Treas. Reg. § 1.897-1(d)(2) (1986). "Real property" includes land, unsevered natural products of the land, such as growing crops and timber, and mines, wells and other natural deposits. "Real property" also includes improvements on land, such as buildings and other inherently permanent structures. Treas. Reg. § 1.897-1(b) (1986).

154. I.R.C. § 897(c)(6)(B) (1986). This includes property used in mining, forestry, and farming (including draft animals); property used in the improvement of real property (including earth moving equipment); property used in the operation of a lodging facility; and property used in the rental of furnished office and other work space. Treas. Reg. § 1.897-1(b)(4) (1986).

155. I.R.C. § 897(c)(1)(A)(ii) (1986). A USRPI will not include any interest in a domestic corporation if: (a) at the time the foreign investor disposes of it, the corporation does not own any USRPIs; and (b) during the shorter of the period after June 18, 1980 during which the taxpayer held such interest, or the five-year period ending on the date of disposition of the foreign investor's interest, either all USRPIs held by the domestic corporation were disposed of in transactions where all the gain was recognized or USRPI status was terminated. I.R.C. § 897(c)(1)(B) (1986).

156. I.R.C. § 897(c)(2) (1986).

157. Treas. Reg. § 1.897-1(f)(1)(iii) (1986).

for publicly traded securities if, after applying modified section 318(a) attribution rules,[158] the foreign investor owns more than five percent of the class of securities disposed of. This could cause the stock to be deemed a USRPI.[159] To satisfy this exception, the securities must be traded on a public market.[160] For purposes of determining the fair market value of a USRPHC's assets, and thus whether more than fifty percent of the fair market value of a corporation's assets consists of USRPIs, the regulations provide "look through" rules which apply up through chains of corporations to the extent that corporations hold a fifty percent or more interest in another corporation.[161] The "look through" rules attribute to the corporation holding a controlling interest in another corporation a portion of each asset of the controlled corporation in proportion to the value of its ownership interest.[162] The aim is to avoid subversion of the ownership rules, or alternatively, flooding a corporation with non-USRPI assets, in order to escape classification as a USRPHC. If a foreign investor disposes of an interest in a foreign corporation, the source rules will apply to exempt any such gain from United States taxation.[163]

Where a USRPI is exchanged, nonrecognition provisions of the Code apply only if the disposition of the property received in exchange for the USRPI would be subject to tax.[164] Thus, with respect to the disposition of a USRPI, it was the general rule prior to TRA 86 that liquidating distributions pursuant to sections 331, 336, 337, and 338 were taxable; non-liquidating distributions pursuant to sections 301, 302, and 311 were taxable; and nonrecognition transactions pursuant to sections 332, 351, 453, 1031, 1034, and the reorganization provisions were not taxable. The repeal by TRA 86 of the *General Utilities* doctrine[165] impacts sections 897(d) and (e), in that post-TRA 86 liquidations will generally be taxable under rules applicable to United States taxpayers. Accordingly, there will be fewer nonrecognition possibilities for either foreign or United States investors in real property.

A foreign corporation holding a USRPI, and entitled to nondiscrim-

158. *See* I.R.C. § 897(c)(6)(C) (1986).

159. I.R.C. § 897(c)(3) (1986).

160. Treas. Reg. § 1.897-1(m) (1986). The public market need not be a domestic market. *Id.*

161. I.R.C. §§ 897(c)(4), (5) (1986); Treas. Reg. § 1.897-1(e) (1986).

162. *Id.*

163. I.R.C. § 865(a)(2) (1986). But note that under I.R.C. § 897(d)(1) (1986), the buyer will retain the corporation's basis in the USRPI after the sale.

164. I.R.C. § 897(e) (1986).

165. Pub. L. No. 99-514, §§ 631-634, 100 Stat. 2085, 2269-2282 (1986).

inatory treatment with respect thereto under a treaty with the United States, may elect to be treated as a domestic corporation.[166] This would result in any gain or loss from the disposition of the USRPI being treated as effectively connected with the conduct of a trade or business in the United States.[167] The election must contain a waiver of treaty benefits with respect to gain or loss on the disposition of a USRPI and a consent to be taxed on such gain, or on gain from the disposition of any property received in a nontaxable exchange.[168]

In lieu of reporting requirements, the transferee must deduct and withhold a tax equal to ten percent of the amount realized upon the disposition of a USRPI.[169]

Four principal effective dates must be considered. The provisions of section 897 are generally effective for dispositions made after June 18, 1980.[170] The reporting requirements apply to calendar years beginning in 1980, with calendar year 1980 beginning on June 19, 1980.[171] In the case of conflict with a particular income tax treaty obligation, gain was generally not taxed to a foreign investor until after December 31, 1984.[172] Where a USRPI was disposed of after December 31, 1979 to a related party, the related party does not get a step-up in basis for untaxed gain if: (1) the disposition took place before June 19, 1980, or (2) a treaty obligation of the United States prevents taxation of gain by the United States.[173]

5. Branch Profits Tax

Branches of foreign corporations operating in the United States are subject to a tax of thirty percent on the branch's "dividend equivalent amount"[174] and on certain interest allocable to effectively connected income[175] absent a specific Code exemption or treaty provision. The branch profits tax is imposed in addition to the tax that a foreign corporation might pay under sections 882 or 897.[176]

166. I.R.C. § 897(i)(1) (1986); Treas. Reg. § 1.897-3(c) (1986).
167. Treas. Reg. § 1.897-3(a) (1986).
168. Treas. Reg. § 1.897-3(c) (1986).
169. I.R.C. § 1445 (1986). *See also infra* notes 361-443 and accompanying text.
170. Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, § 1125, 94 Stat. 2682, 2690-91 (1980).
171. *Id.*
172. *Id.*
173. *Id.*
174. I.R.C. § 884(a) (1986).
175. I.R.C. § 884(f) (1986).
176. I.R.C. § 884(a); CONF. REP. NO. 841, 99th Cong., 2d Sess. II-647 (1986).

A branch includes not only the United States operation of a foreign corporation,[177] but also a partnership interest in a partnership conducting business in the United States,[178] and vessels or aircraft owned by a foreign corporation if they generate income effectively connected with the United States.[179] While this statement is not repeated in the Conference Report, the statute makes it clear that the branch profits tax applies to any interest giving rise to such income.[180]

The "dividend equivalent amount" is the branch's United States "effectively connected earnings and profits" for the taxable year as determined after adjustments for increases and decreases in the foreign corporation's "U.S. net equity"[181] to reduce the tax base in the case of reinvestment and to increase the tax base in the case of repatriation of the investment in the United States. The dividend equivalent amount is limited to the foreign corporation's yearly post-1986 accumulated earnings and profits which are treated as effectively connected.[182] It is also decreased by deficits in post-1986 accumulated earnings and profits.[183] The term "effectively connected earnings and profits" is specially defined so as not to include earnings and profits attributible to certain income.[184]

Limiting the dividend equivalent amount to a branch's effectively connected earnings and profits insures that the branch can lower its income by taking into account domestic and foreign taxes, capital losses not allowed in computing taxable income, and other adjustments which would be made if the branch were a subsidiary calculating its earnings and profits. A branch taking accelerated depreciation for taxable income purposes, however, would be required to use depreciation methods specified under the rules for determining earnings and profits.[185] It is important to note also that dividend distributions will not reduce the branch's earnings and profits.[186]

177. S. REP. No. 313, 99th Cong., 2d Sess. 403 (1986).
178. *Id.*
179. *Id.*
180. I.R.C. § 884 (1986).
181. I.R.C. § 884(b) (1986).
182. *Id.*
183. I.R.C. § 884(b)(2)(B) (1986).
184. I.R.C. § 884(d)(2) (1986). These exceptions include certain earnings derived by foreign sales corporations under sections 921(d) and 926(b); earnings derived by foreign transportation carriers that are exempt from United States tax pursuant to either a treaty or a reciprocal exemption; earnings derived from the sale of any USRPI, excluding an interest in a foreign corporation which is a USRPHC; earnings derived by certain possessions corporations, described in section 881(b); and earnings derived by certain captive insurance companies that elect, under section 953(c)(3)(C), to treat their income as being effectively connected. *Id.*
185. CONF. REP. No. 841, *supra* note 176, at II-648.
186. *Id.*

"U.S. net equity" is comprised of money and the aggregate adjusted bases of property (as determined for purposes of computing earnings and profits of those assets) and liabilities treated as connected to the branch's operations which generate United States effectively connected income.[187] Regulations will be issued which will track the general rules for allocating an interest deduction under section 882(c)(1).[188] Assets used in the calculation of U.S. net equity include those assets necessary to allow the branch to meet its daily operating requirements, receivables incurred in the branch's United States operations, inventories, property, plant and equipment used in the branch's operations, and such other assets as may be required to operate the branch's business.[189] Liabilities used in the calculation include the daily payables and short term obligations, long term obligations incurred to purchase assets used in the branch's business, and other liabilities related to the branch's United States effectively connected income.[190]

The dividend equivalent amount is adjusted by an amount equal to the increase or decrease in the branch's U.S. net equity.[191] The dividend equivalent amount is also decreased, but not below zero, by an amount equal to the branch's investment of its income in the United States.[192] If the reinvested earnings which have deferred the branch profits tax are later repatriated by the home office, the amount repatriated acts to increase the tax base for branch profits tax purposes for the year of repatriation.[193] To calculate the amount of increase to the tax base, the net assets at the beginning of the year are compared with the net assets at the end of the year.[194] If the net equity diminishes, the dividend equivalent amount goes up in an amount not to exceed, however, the amount previously deferred.[195]

Any interest paid by a branch is treated as if it were a payment of interest by a United States subsidiary to its foreign corporate parent, and thus, is subject to a thirty percent withholding tax, unless reduced or

187. I.R.C. § 884(c)(2) (1986).

188. Treas. Reg. § 1.882-5 (1986).

189. S. REP. No. 313, *supra* note 177, at 404.

190. *Id.*

191. I.R.C. § 884(b) (1986).

192. *Id.* This adjustment is determined by comparing the adjusted bases, for purposes of computing earnings and profits, of those branch assets reduced by liabilities, treated as connected with the conduct of a trade or business in the United States at the beginning of the year with those assets' bases at the end of the year (less liabilities).

193. S. REP. No. 313, *supra* note 177, at 403.

194. I.R.C. § 884(b)(1) (1986).

195. I.R.C. § 884(b)(2) (1986).

eliminated by a specific Code or treaty provision.[196] If an interest deduction is allocated to a branch which exceeds the interest actually paid by the branch to its foreign parent, the excess will be treated as interest on a notional loan from the foreign parent paid on the last day of the parent's taxable year.[197] Thus, the excess will be subject to a thirty percent withholding tax, unless reduced or eliminated by a specific Code or treaty provision.[198]

Regulations may provide that where the indebtedness of the foreign parent is allocated to the branch, the interest so allocated which exceeds the interest actually paid will be treated as though it were incurred by the foreign parent on each type of external borrowing, and determined by reference to the relative principal amounts of, and average interest rate on, the foreign parent's external borrowing. Put more simply, interbranch loans must resemble the foreign corporation's borrowings from external sources. Structuring of interbranch loans which are different from the foreign parent's external borrowings will be specifically addressed in future regulations, as a result of the conferees' concern that such structuring may be artificial.[199]

The Technical Corrections Act of 1987 makes clear that interest paid of deducted by a branch is United States source income, regardless of the recipient. Accordingly, if the recipient is foreign and not engaged in a trade or business in the United States, the interest will be subject to withholding, and if the recipient is either a United States person or engaged in a United States trade or business, no withholding will apply.[200]

Prior to the Technical Corrections Act of 1987, section 884(e)(3) provided that "[i]f a foreign corporation is not exempt for any taxable year from the tax imposed by subsection (a) by reason of a treaty, no tax shall be imposed by section 871(a), 881(a), 1441, or 1442 on any dividends paid by such corporation during such taxable year."[201] This language may have allowed dividends paid to any foreign corporation with a United States operating branch to be free from a second-level withholding tax. The Technical Corrections Act of 1987 changed section 884(e)(3) to read:

> [i]f a foreign corporation subject to the tax imposed by section (a) for every taxable year (determined after the application of any treaty), no

196. I.R.C. § 884(f)(1)(A) (1986).
197. Treas. Reg. § 1.882-5 (1986).
198. CONF. REP. No. 841, *supra* note 176, at II-648-49.
199. *Id.*
200. Technical Corrections Act of 1987, H.R. 2636, 100th Cong. § 112(o)(9) (1987).
201. I.R.C. § 884(e)(3) (1986).

> tax shall be imposed by section 871(a), 881(a), 1441, or 1442 on any dividends paid by such corporation out of its earnings and profits for such taxable year.[202]

This makes clear that the withholding tax on dividends may be imposed in two cases: (1) on dividends attributable to pre-1987 earnings and profits and (2) on dividends attributable to earnings and profits where the branch profits tax is prohibited by a tax treaty, regardless of where the dividends are distributed.[203]

If a foreign corporation is a resident of a country with which the United States has a tax treaty, the rate of the branch profits tax will be either the rate of tax specified in the treaty, or, if no such rate is specified, the rate of tax applicable to dividends of a corporation of one contracting state paid to a resident of the other contracting state who owns all the stock of the corporation. Any other limitations on the branch profits tax under the treaty will apply.[204] This rate reduction will not apply unless the foreign corporation is a qualified resident of the treaty country, or the treaty permits withholding on second-level dividends,[205] paid by the foreign corporation.[206] Note, however, that under the Technical Corrections Act of 1987, the rate reduction applies only if the foreign corporation is a qualified resident of the treaty country.[207]

The branch profits tax seriously affects the United States income tax treaty network by generally limiting treaty benefits to "qualified residents" of our treaty partners.[208] Section 884(e)(4)(A) generally defines a qualified resident as a foreign corporation that is a resident of the foreign country[209] and whose value is more than fifty-percent (changed by the Technical Corrections Act of 1987 to fifty percent or more[210]) owned by individuals who are residents of either the United States or the country where the foreign corporation is a resident.[211] A foreign corporation

202. Technical Corrections Act of 1987, H.R. 2636, 100th Cong. § 112(o)(2)(B) (1987).

203. *Id.*

204. I.R.C. § 884(e)(2) (1986).

205. *See* I.R.C. § 861(a)(2)(B) (1986).

206. I.R.C. § 884(e)(1) (1986).

207. Technical Corrections Act of 1987, H.R. 2636, 100th Cong., 1st Sess. § 112(o)(2)(A) (1987).

208. I.R.C. § 884(e)(1)(A) (1986), which, under the Technical Corrections Act of 1987, becomes I.R.C. § 884(e)(1).

209. I.R.C. § 884(e)(4)(A) (1986).

210. Technical Corrections Act of 1987, H.R. 2636, 100th Cong., 1st Sess. § 112(o)(5) (1987).

211. I.R.C. § 884(e)(4)(A)(i) (1986). The foreign corporation will also be a qualified resident if more than 50% of its income is used to meet liabilities of individuals who are residents of either the United States or the foreign country. I.R.C. § 884(e)(4)(A)(ii) (1986).

need not be incorporated in the foreign country, if it is otherwise a resident there, in order to be deemed a qualified resident.[212] This treaty shopping limitation does not apply to any foreign corporation whose stock or parent's stock[213] is primarily and regularly traded on an established securities market in the country of which the foreign corporation and, if applicable, its parent are residents.[214] The Treasury Secretary has been given the discretion to treat a foreign corporation as a qualified resident if the foreign corporation can demonstrate that any treaty shopping is not taking place.[215]

If a foreign corporation is a resident of a country with which the United States has a tax treaty prohibiting the imposition of a branch profits tax, the branch profits tax shall not apply unless a taxpayer is involved in treaty shopping.[216] Thus, where a treaty contains a nondiscrimination clause which provides that a contracting state will not tax the permanent establishment in that state of an enterprise of the other contracting state less favorably than one of its own enterprises carrying on the same activities,[217] the treaty will prevail over the branch profits tax if the foreign corporation is a qualified resident of the treaty country.[218] Prior to the Technical Corrections Act of 1987,the treaty would also have prevailed if it permited withholding on second-level dividends and the foreign corporation actually paid the tax.[219]

The income tax treaties between the United States and Argentina, Australia, Barbados, Canada, Denmark (recently superceded), France, Netherlands Antilles (recently superceded), New Zealand, Poland, Romania, South Africa, Trinidad and Tobago, and the USSR expressly provide for a branch profits tax.[220] The United States' older treaties, such as those with Austria, Germany, Greece, Ireland, Luxembourg, Pakistan, Sweden, and Switzerland do not address whether a branch

212. *See* I.R.C. § 884(e)(4) (1986).

213. In order for this exception to apply to a foreign corporation through the public trading of its parent's stock, the parent must wholly own such corporation and be incorporated in the same foreign country. I.R.C. § 884(e)(4)(B)(ii) (1986).

214. I.R.C. § 884(e)(4)(B) (1986).

215. I.R.C. § 884(e)(4)(C) (1986).

216. I.R.C. § 884(e)(1)(A) (1986).

217. *See, e.g.*, OECD Model Convention, Tax Treaties (CCH) ¶ 151 at 215-2 (1980); Treasury Department's Model Income Tax Treaty of May 17,1977, Tax Treaties (CCH) ¶ 153 at 233; Treasury Department's Model Income Tax Treaty, Model of June 16, 1981, Tax Treaties (CCH) ¶ 158 at 263-64.

218. I.R.C. § 884(e)(4) (1986).

219. I.R.C. § 884(e)(1)(B) (1986); Technical Corrections Act of 1987, H.R. 2636, 100th Cong., 1st Sess. § 112(o)(2)(A) (1987).

220. *See generally* Tax Treaties Reporter (CCH) *passim* (1985).

which is a permanent establishment in the other state, or a corporation which is a citizen of the other state, is eligible for relief under this type of nondiscrimination clause.[221] Although research provides no certain answer, the policy underlying nondiscrimination clauses, together with internal United States law,[222] would lead one to conclude that nondiscrimination clauses should apply to these branches. Congress is apparently satisfied that it is wise international policy to unilaterally adopt a definitional regimen which permits the override of approximately thirty-two treaties.

6. Deductions

Deductions from the gross income of a nonresident alien individual are generally allowed only to the extent that they are effectively connected with the conduct of a trade or business within the United States.[223] Certain deductions, however, are allowed whether or not they are effectively connected with a trade or business in the United States. These include certain casualty or theft losses of property located in the United States, charitable contributions, and one personal exemption unless the taxpayer is a resident of a contiguous country.[224] Allowance of these deductions is contingent upon filing a return.[225]

C. Estate Tax

1. Situs Rules

The tax base for the estate tax is defined as property situated within the United States.[226] For example, the physical location of real property determines its situs for estate tax purposes.[227] Mortgages and liens upon real property do not constitute real property.[228]

While the situs of tangible property depends upon its permanent location,[229] the status of the owner on the date of death may be relevant. For example, if a nonresident alien dies in the United States, the situs of tangible personal property in his possession will not be deemed to be the United States. Rather, the situs of such tangible property will be deter-

221. *Id.*
222. *See* Priv. Ltr. Rul. 7,846,060 (Aug. 18, 1978).
223. I.R.C. § 873(a) (1986).
224. I.R.C. § 873(b) (1986).
225. I.R.C. § 874(a) (1986).
226. I.R.C. §§ 2103-2105 (1986).
227. Treas. Reg. §§ 20.2104-1(a)(2), 20.2105-1(a)(2) (1986).
228. Estate of Tarafa y Armas, 37 B.T.A. 19 (1938).
229. Treas. Reg. §§ 20.2104-1(a)(2), 20.2105-1(a)(2) (1986).

mined analogously to the domicile of an individual.[230] Works of art on loan for exhibition in the United States are excepted from this rule.[231] It has also been ruled that currency is tangible property, and thus, its situs governs taxability.[232]

The situs of intangible property depends upon its nature. Shares of a United States corporation are deemed situated in the United States, regardless of the location of the certificates.[233] Stock of a foreign corporation, on the other hand, has its situs outside the United States, regardless of the location of the certificates.[234]

Debt obligations of a United States person or governmental entity are deemed situated in the United States, whether or not the written evidence of the debt obligation is treated as being the property itself.[235] A debt obligation is deemed foreign property if the primary obligor is neither a United States person nor a United States govermental entity.[236] A pre-TRA 86 debt obligation of a so-called "80-20" company[237] was treated as foreign property if it qualified under section 861(a)(1)(B).[238] Although the Conference Report on TRA 86 is silent, it appears likely that the "active foreign business income" requirement of section 861(c), which replaces the 80-20 concept under the 1954 Internal Revenue Code,[239] will carry over to section 2105, as a result of technical corrections.

As a result of the Technical Corrections Act of 1987, it is now certain that interest on bank and savings and loan deposits, as well as interest on deposits with an insurance company, will be considered foreign property for estate tax purposes if the interest on such deposits is not effectively connected with the conduct of a United States trade or business.[240] Funds held by a United States bank as a fiduciary, rather than as a depository, renders the funds United States property.[241] Cash in a

230. Delaney v. Murchie, 177 F.2d 444, 448 (1st Cir. 1949).

231. I.R.C. § 2105(c) (1986).

232. Priv. Ltr. Rul. 7,737,063 (June 17, 1977).

233. I.R.C. § 2104(a) (1986); Treas. Reg. § 20.2104-1(a)(5) (1986).

234. Treas. Reg. § 20.2105-1(f) (1986).

235. I.R.C. § 2104(c); Treas. Reg. § 20-2104-1(a)(7) (1986).

236. Treas. Reg. § 20-2105-1(k) (1986).

237. See I.R.C. 861(a)(1)(B) (1985) for a definition of an "80-20" company.

238. Treas. Reg. § 20.2105-1(l) (1986).

239. I.R.C. § 861(a)(1)(A) (1986).

240. I.R.C. § 2105(b)(1) (1986). *See also* I.R.C. § 871(i) (1986); Technical Corrections Act of 1987, H.R. 2636, 100th Cong., 1st Sess. § 112(f)(4) (1987).

241. Rev. Rul. 69-596, 1969-2 C.B. 179. *But see* Isidro Martin-Montis Trust v. Commissioner, 75 T.C. 381 (1980); Rev. Rul. 82-193, 1982-2 C.B. 219; Rev. Rul. 81-244, 1981-2 C.B. 151, which have substantially qualified Rev. Rul. 69-596.

United States safety deposit box is also United States property,[242] as is cash left with a United States brokerage house.[243]

Portfolio interest obligations described in Section 871(h) are deemed situated outside the United States,[244] as are life insurance proceeds.[245] Where the beneficiary is the decedent rather than another who is insured, however, the proceeds constitute a debt of the United States obligor—the insurance company—and are thus treated as United States situs property.[246] Unless otherwise specified in Treasury Regulations 20.2104-1 or 20.2105-1, the situs of intangible property, written evidence of which is not deemed as being the property itself, depends on the person against whom the right is enforceable or by whom the right is issued.[247]

Any property which is deemed to be a revocable transfer, a transfer taking effect at death, a transfer with a retained life estate, or a transfer within three years of death, is deemed situated in the United States if the property was so situated either at the time of transfer or at the time of death.[248] Section 2104(b), however, would likely not bring into the estate tax base a lifetime transfer by a nonresident alien individual, exempt from gift tax,[249] who becomes a resident of the United States and dies within three years of making the gift. Also, under ERTA, for decedents dying after 1981, transfers within three years of death will only be included in the decedent's taxable estate under limited circumstances.[250]

The form of ownership of property is determined by foreign law,[251] but tax consequences are determined under United States law.[252] The foregoing situs rules are subject to variation by treaty.[253]

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242. Rev. Rul. 55-143, 1955-1 C.B. 465.
243. Rev. Rul. 65-245, 1965-2 C.B. 379.
244. I.R.C. § 2105(b)(3) (1986).
245. I.R.C. § 2105(a) (1986).
246. Treas. Reg. § 20.2104-1(a)(7) (1986).
247. Treas. Reg. § 20.2104-1(a)(4) (1986).
248. I.R.C. § 2104(b) (1986).
249. *See infra* notes 254-60 and accompanying text.
250. I.R.C. § 2035(d)(3) (1986). Indeed, the estate tax base includes property deemed incompletely transferred under the "string powers" provisions of sections 2035-2038. Section 2035 generally includes in the taxable estate gifts made within three years of death. As a result of ERTA, the applicability of section 2035 to the estates of decedents dying after 1981 is somewhat curtailed.
251. Sanchez v. Bowers, 70 F.2d 715 (2d Cir. 1934).
252. Estate of Swan v. Commissioner, 247 F.2d 144 (2d Cir. 1957).
253. Treas. Reg. § 20.2104(1)(c) (1986).

D. Gift Tax

1. Source Rules

A taxable transfer includes only United States real property, or tangible personal property whose situs is within the United States, and only to the extent that the pre-1982 transfer exceeds the $3,000 present interest annual exclusion.[254] Regarding post-1981 transfers, the gift tax present interest annual exclusion is increased to $10,000.[255] There is also an unlimited exclusion for amounts paid for the benefit of a donee for certain medical expenses and school tuition.[256]

Intangible property may be included in the tax base where the gift was made in connection with a tax-motivated expatriation.[257] The situs of real property is determined by its physical location.[258] The situs of tangible property also depends upon its physical location.[259] The foreign investor should note the absence of an exclusion for loaned works of art which would be similar to the estate tax base exclusion found in section 2105(c). The situs of intangible personal property for gift tax purposes is determined in much the same way as for estate tax purposes.[260]

V. WITHHOLDING

A. Generally

As a means of collection, Internal Revenue Code sections 1441 through 1445 impose a regimen of withholding for payments of fixed or determinable, annual or periodical income (FDAP) to nonresident aliens (FDAP Withholding), and for gains received by a nonresident alien on the disposition of a USRPI (USRPI Withholding).[261] TRA 86 establishes yet another, albeit embryonic, withholding regimen under new section 1446. This provision applies to post-1987 distributions to foreign partners of partnership gain or loss that is deemed to be effectively connected with the conduct of a United States trade or business (Partnership

254. I.R.C. §§ 2501(a)(2), 2511 (1986); I.R.C. § 2503(b) (before amendment in Pub. L. No. 97-34 § 441(a), 95 Stat. 172, 319 (1981).

255. I.R.C. § 2503(b) (1986).

256. I.R.C. § 2503(e) (1986).

257. I.R.C. § 2501(a)(2)-(3) (1986).

258. Treas. Reg. § 25.2511-3(b)(1) (1986).

259. *Id.*

260. *See* Treas. Reg. § 25.2511-3(b)(2)-(4) (1986).

261. I.R.C. §§ 1441-1445 (1986). The former is extensively dealt with in an article by Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX. L. REV. 49 (1980), upon which the analysis herein draws heavily, and with gratitude. The latter was added by DEFRA.

Withholding).[262]

B. FDAP Withholding

1. Elements of the Requirement to Withhold

If the requirement to withhold on FDAP exists, the tax is imposed on gross income, without reference to deductions,[263] at the rate of thirty percent, unless varied by treaty.[264] This results in the United States attracting revenue with greater speed and certainty than if it waited for the nonresident alien to file a return.

There are essentially six elements of the requirement to withhold on FDAP: (1) the payment must constitute United States source income; (2) it must be FDAP; (3) it must be income other than effectively connected income; (4) the payee or recipient must be a foreign corporation, foreign partner, foreign partnership, or other nonresident alien; (5) there must be a withholding agent; and (6) no special relief from withholding exists.[265]

a. *United States Source Income*

United States source income has the meaning accorded it in sections 861 through 863, as well as 865 and 871, as amended by TRA 86.[266]

b. *FDAP*

FDAP is defined by the regulations, which state that:

> Income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals.[267]

Although many commentators regard this definition as being "so broad as to be virtually meaningless,"[268] several applications of it have been identified. A relatively recent decision has held that patronage dividends are "clearly" FDAP on the basis of the above-quoted language.[269] While

262. I.R.C. § 1446 (1986).
263. Rev. Rul. 73-522, 1973-2 C.B. 226.
264. I.R.C. §§ 871(a)(1), 881(a) (1986); Treas. Reg. § 1.1441-1 (1986).
265. *See generally* I.R.C. §§ 1441-1446 (1986).
266. Treas. Reg. § 1.1441-3(a) (1986).
267. Treas. Reg. § 1.1441-2(a)(2) (1986).
268. *See, e.g.,* S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS VII-3 (1966).
269. Coastal Chemical Corporation v. United States, 546 F.2d 110 (5th Cir. 1977). *See*

a gain from the sale or exchange of property, whether or not a capital asset, does not constitute FDAP,[270] gain from the sale or exchange of a USRPI, although not FDAP, is subject to tax and withholding.[271]

c. *Non-Effectively Connected Income*

Withholding does not apply to effectively connected income.[272] Withholding, however, will apply to personal service income, even if it is effectively connected income.[273]

d. *Foreign Corporation, Partner, Partnership, or Other Nonresident Alien*

The payee or recipient must be a foreign corporation, foreign partner, foreign partnership, or other nonresident alien. A foreign corporation is one "created or organized" under the laws of a jurisdiction which is not a state or the United States itself.[274] A foreign partnership is similiarly defined.[275] The section 7701(b) definition of nonresident alien applies for these purposes. Because the Code definition is tautological,[276] whether the status of a trust or estate is foreign depends upon a number of factors which are generally tested in the same manner as the status of an individual.[277] In this connection, concepts of "residence" and "foreign status" must be distinguished. For corporations and partnerships, withholding turns on "foreign status," which is determined by whether the entity engages in a trade or business within the United States.[278] The entity's "residence" is disregarded unless either the income is effectively connected income,[279] or the Office of International Operations has ex-

Rev. Rul. 66-53, 1966-1 C.B. 206; Rev. Rul. 58-479, 1958-2 C.B. 60, *made obsolete by* Treas. Reg. § 1.1441-4(b)(v) (1986).

270. Treas. Reg. § 1.1441-2(a)(3) (1986).

271. I.R.C. §§ 897(a) and 1445 (1986). *See also infra* notes 361-443 and accompanying text.

272. I.R.C. §§ 1441(c)(1), 1442, 864(c). *See also supra* notes 147-52 and accompanying text.

273. I.R.C. § 1441(c)(1) (1986).

274. I.R.C. §§ 7701(a)(3)-(5) (1986). This is a relatively straightforward definition. One looks at the jurisdiction issuing the gold seal on the articles of incorporation of the entity (the "Gold Seal" rule).

275. I.R.C. § 7701(a)(2), (4)-(5) (1986). Note the unavailability of the "Gold Seal" rule in this situation. It is, therefore, difficult to pinpoint the juridical personality of the partnership.

276. I.R.C. § 7701(a)(31) (1986).

277. I.R.C. § 641(b) (1986); Treas. Reg. § 1.871-2(a) (1986). *See also* B.W. Jones Trust v. Commissioner, 46 B.T.A. 531, *aff'd*, 132 F.2d 914 (4th Cir. 1943); Rev. Rul. 62-154, 1962-2 C.B. 148; Rev. Rul. 60-181, 1960-1 C.B. 257.

278. Treas. Reg. § 301.7701-5 (1986).

279. *Id.*

cused withholding.[280] For individuals, trusts, and estates, however, both nonresidence and foreign status must be present for withholding.[281]

e. *Withholding Agent*

The Code defines a withholding agent as "any person required to deduct and withhold any tax under the provisions of sections 1441, 1442, 1443, or 1461."[282] This definition is conclusory, but is nonetheless augmented by Treasury Regulation § 1.1465-1(a)(1),[283] which adds to the definition of a withholding agent every person who pays income of the type subject to withholding to a nonresident alien individual or foreign entity, even though withholding is not required on such income. Section 1441(a) requires withholding by:

> all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income [subject to withholding] . . . of any nonresident alien individual or of any foreign partnership . . . .

In addition, section 1442(a) requires withholding on payments to foreign corporations "in the same manner" as required under section 1441(a). Thus, a bank which made a payment from an account to a foreign bank was held to be a "mere conduit" and not "the primary source where payment was coming from" and was, therefore, not a withholding agent.[284]

Examples of improbable withholding agents include: a renter of a condominium owned by a foreign person;[285] a guarantor who makes a payment of United States-source interest on the debt of another;[286] a

280. Treas. Reg. § 1.1441-4(f) (1986).

281. *See* Treas. Reg. § 1.1441-1 (1986).

282. I.R.C. § 7701(a)(16) (1986).

283. I.R.C. § 1465, to which this regulation is appended, was repealed by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1986 (1976).

284. Bank of America, N.T. & S.A. v. Chaco, 79-1 U.S. Tax Cas. (CCH) ¶ 9232 (D.C. Guam 1979). *See also* Isidro Martin-Montis Trust v. Commissioner, 75 T.C. 381 (1980).

285. Rev. Rul. 73-522, 1973-2 C.B. 226. *See also* Priv. Ltr. Ruls. 7,904,019 (Oct. 14, 1978); 7,750,063 (Sept. 19, 1977).

286. The source of the interest depends on the residence of the original obligor at the time of payment. Treas. Reg. §§ 1.861-2(a)(5), 1.862-1(a)(5); Rev. Rul. 70-377, 1970-2 C.B. 175. These rules do not deal with the question of determining the identity of the "real" primary obligor. *See generally* Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972); Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967). The original obligor is probably not a withholding agent because it does not have "control, receipt, custody, disposal, or payment" of the funds, when payment is made by

United States resident ex-spouse who pays alimony to the nonresident alien ex-spouse, although all incidents of payment and marriage are foreign;[287] and a United States spouse who is a resident of a community property state with regard to one-half of his or her income which, under community property laws, is deemed to belong to the nonresident alien spouse.[288]

A person may be a withholding agent in the case of a "constructive" payment. Examples include a United States parent corporation which merely credits interest to its foreign subsidiary,[289] and a United States resident whose foreign margin account is charged with interest.[290] The duty to withhold could also follow a section 482 allocation.[291]

Under some circumstances, even a foreign entity can be a withholding agent. The Service has held that a foreign corporation has the duty to withhold on wages and FICA, although the situation came under provisions of the United States-Canadian tax treaty.[292] The ruling contained no facts indicating a nexus with the United States, except that the employees in question were temporarily within the United States and the foreign corporation in question was a subsidiary of a United States corporation.[293] The proposed original issue discount regulations appear to require a foreign person to be a withholding agent, regardless of the absence of contacts with the United States, where the foreign person pays

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the guarantor. Tonopah & T.R.R. v. Commissioner, 112 F.2d 970 (9th Cir. 1940). Thus, a guarantor can become a withholding agent. *Cf.* Treas. Reg. § 1.1441-3(c)(2) (1986).

287. Lamm v. Commissioner, 36 T.C.M. (CCH) 1345 (1977); Lamm v. Commissioner, 34 T.C.M. (CCH) 473 (1975). Note that although sections 861 and 862 provide no specific rule, alimony is pigeon-holed as a debt of the payor for source purposes. While not necessarily sensible, this view is supported by precedent. Manning v. Commissioner, 38 T.C.M. (CCH) 646 (1979); Howkins v. Commissioner, 49 T.C. 689 (1968); Rev. Rul. 65-283, 1965-2 C.B. 25. Also, competent authority procedures under various tax treaties are probably not available for disposing of alimony claims. *Cf.* Rev. Rul. 54-53, 1954-1 C.B. 156.

288. Rev. Rul. 72-546, 1972-2 C.B. 435. Note that as to earned income the result may be different by virtue of section 879(a)(1), added by the Tax Reform Act of 1976. Query the effect of an existing section 6013(g) election which, by virtue of section 879(b), would make section 879(a)(1) inapplicable. Treas. Reg. § 1.879-1 (1986). Because the section 6013(g) election is, by its terms, only effective for chapter 1 and not for chapter 3, would section 879(a)(1) be available for withholding purposes? Nonetheless, the withholding requirement would still apply to unearned income, such as dividends. In this regard, see Rev. Rul. 57-299, 1957-2 C.B. 606, where a dividend-paying corporation was deemed a wthholding agent as to one-half of dividends paid in respect of stock which was held jointly by a married couple, one of whom was a nonresident alien.

289. Rev. Rul. 70-251, 1970-1 C.B. 183.

290. Rev. Rul. 71-142, 1971-1 C.B. 265.

291. *Cf.* Foster v. United States, 329 F.2d 717 (2d Cir. 1964).

292. Rev. Rul. 76-19, 1976-1, C.B. 441.

293. Rev. Rul. 79-391, 1979-2 C.B. 352 operates to the same effect where employees are not permanent.

interest on post-March 31, 1972 obligations.[294]

The ability of a foreign entity to be a withholding agent gives rise to the "cascade" effect of United States source-of-income rules in such cases as royalties paid through chains of licensees and sublicensees. Thus, although a treaty exemption might be sufficient to eliminate the withholding requirement at the first tier (*i.e.*, between the United States sublicensee and its treaty-partner-domiciled sublicensor), payment at the second tier (*i.e.*, between the United States-treaty-partner sublicensor and the non-treaty-partner licensor) would still constitute a payment of United States-source income, and would thus require the foreign payor to act as withholding agent.[295] Clearly, a resident alien or a foreign person who is engaged in a trade or business may be a withholding agent.[296]

f. *Special Relief from Withholding*

There are two kinds of special relief available from FDAP withholding: (1) treaty rules and (2) special rules under the regulations. For example, the regulations providing for withholding on payments to non-individual foreign payees is not required, if the payees are engaged in a trade or business, and if the Office of International Operations determines both that an undue administrative burden would exist and that ultimate collection of tax would not be jeopardized.[297]

2. Exceptions to the System

Some "sale or exchange" transactions may result in "deemed" FDAP from United States sources, but gain from the sale or exchange of an asset generally will not be subject to withholding.[298] Examples of deemed FDAP include certain gains from the sale or exchange of patents, copyrights, and other like property,[299] and gain from the sale or exchange of "section 306 stock."[300]

Also of interest to the foreign investor is the treatment of dividend-

294. Prop. Treas. Reg. § 1.1441-3(c)(6)(i)(D), 41 Fed. Reg. 28,517, 28,522 (1976).

295. *See* Rev. Rul. 80-362, 1980-2 C.B. 208; Treasury Department's Model Income Tax Treaty, (Model of June 16, 1981), Tax Treaties (CCH) ¶ 158 (confirming this analysis).

296. Rev. Rul. 71-142, 1971-1 C.B. 265 (resident alien); Treas Reg. § 1.1441-3(b)(2)(ii) (foreign corporation engaged in United States trade or business).

297. Treas. Reg. § 1.1441-4(f) (1986).

298. Treas. Reg. § 1.1441-2(a)(3) (1986).

299. I.R.C. §§ 871(a)(1)(D), 881(a)(4) (1986).

300. *See* I.R.C. § 306(f) (1986). While the gain in all of the above examples is clearly United States source deemed FDAP, gain from section 306 stock may not be subject to withholding, whereas withholding is clearly required in the other examples. I.R.C. §§ 1441(c)(5), 1442(a); Treas. Reg. § 1.1441-2(b)(2)(iii) (1986).

like payments arising out of sale or exchange transactions under sections 302, 304, 305, and 356. In some cases, there is no withholding agent, because no person has control of the actual payment to the recipient, because there is no actual payment. One of the necessary elements of the requirement to withhold, therefore, is not present. This may be typical in situations under section 305. To the extent that such income is deemed foreign source income, withholding will be avoided. This might cover situations under section 302 involving foreign corporations or domestic 80-20 corporations. Boot dividends under pre-TRA 86 section 356 are apparently not subject to withholding since they are not FDAP.[301] A section 302(d) distribution in redemption has been held to be subject to withholding as FDAP.[302]

Under certain cirumstances, United States source FDAP may not be subject to withholding. One such example is post-Tax Reform Act of 1976 accumulation distributions by trusts under section 667(a). Although fiduciaries making payments of United States source FDAP to foreign beneficiaries are required to withhold,[303] the addition to section 667(a) of the parenthetical clause obliterating tax "character" of all throwback distributions, except those having section 103 character, obliterated the source rule as to such distributions as well.[304] Thus, section 667(e), enacted by the Technical Corrections Act of 1977,[305] restored "character" to accumulation distributions so that withholding could be assured. Arguably, until proposed regulations are adopted, original issue discount is not subject to withholding, except upon redemption.[306] Finally, interest on bonds sold between interest dates is currently not subject to withholding.[307]

Compensation for personal services, although considered effectively connected income, is subject to withholding.[308] This area involves significant questions of treaty interpretation[309] which can vary the withholding

301. I.T. 3781, 1946-1 C.B. 119, *declared obsolete under* Rev. Rul. 69-45, 1969-1 C.B. 313.

302. DeNobili Cigar Co. v. Commissioner, 1 T.C. 673 (1943), *acq.*, 1943 C.B. 6, *aff'd*, 143 F.2d 436 (2d Cir. 1944).

303. Treas. Reg. § 1.1441-3(f) (1986). This duty covers accumulation distributions. *See* Rev. Rul. 68-605, 1968-2 C.B. 390.

304. *See also* Rev. Rul. 55-414, 1955-1 C.B. 85.

305. Pub. L. No. 95-600 § 701(r)(1), 92 Stat. 2763, 2910 (1977).

306. Rev. Rul. 68-333, 1968-1 C.B. 390; I.R.C. §§ 1441(c)(8), 1442(a); Treas. Reg. § 1.1441-4(h); Priv. Ltr. Ruls. 7,917,127 (Jan. 29, 1979); 7,924,081 (Mar. 19, 1979); 7,838,070 (June 22, 1978) (Treasury bills); 7,834,066 (May 26, 1978) (original issue discount on instruments with maturities under six months).

307. *See* Treas. Reg. § 1.1441-4(h) for a concession that such income may be FDAP.

308. I.R.C. § 1441(c)(1) (1986).

309. Numerous Private Letter Rulings exist regarding treaties with Austria, Belgium, Can-

requirement.[310] The relevant rulings and cases generally involve noted foreign artists and athletes.[311] No withholding is required where wage withholding already applies.[312]

3. Obligations and Defenses of the Payor-Withholding Agent

The payor-withholding agent is in the uncomfortable position of being responsible to both the United States and the nonresident alien payee in situations where the decision whether to withhold is very complicated. These situations involve such questions as status and identity of payees, applicability of treaties, and questions as to source and characterization of income. Absent perfection, the withholding agent either under- or over-withholds. In each case, one must examine the rights and liabilities of the withholding agent against the United States and against the payee.

A under-withholding agent is liable to the United States for the entire amount of tax, together with interest and penalties.[313] The tax liability and penalties may be avoided, however, if either the withholding agent or the payee voluntarily pays the tax, although interest will nevertheless be due.[314] Defenses proffered by the withholding agent who under-withholds have thus far fallen into four categories: (1) disclaimer of liability, (2) reliance on counsel, (3) reliance on statements of the foreign payee, and (4) the statute of limitations.

a. *Disclaimer of Liability*

Where a United States corporation hires a paying agent, and the agent fails to withhold, the principal is also liable, even if the agent is an independent and substantial bank. Failure to withhold is not excused even where the agent is "insolvent or for any other reason."[315] Conversely, if the foreign payee appoints a United States tax agent, the payor is still liable if the payee's agent fails to withhold.[316]

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ada, France, Germany, Ireland, Japan, the Netherlands, Poland, Sweden, Switzerland, and the United Kingdom. In this context, the treaty benefit is claimed by a statement under Treasury Regulation § 1.1441-4(b)(2), rather than on Form 1001.

310. Treas. Reg. § 1.1441-4(b)(1)(iv) (1986).

311. *See e.g.*, Johansson v. United States, 336 F.2d 809 (5th Cir. 1964); Rev. Rul. 74-330, 1974-2 C.B. 278; Rev. Rul. 74-331, 1974-2 C.B. 281; Rev. Rul. 75-503, 1975-2 C.B. 352.

312. Treas. Reg. § 1.1441-4(b)(1)(i)-(ii) (1986).

313. I.R.C. § 1461 (1986); Gen. Couns. Mem. 17,274, 1937-1 C.B. 159, *declared obsolete in* Rev. Rul. 69-420, 1969-2 C.B. 264.

314. I.R.C. § 1463 (1986); Treas. Reg. § 1.1463-1 (1986).

315. Treas. Reg. § 1.1465-1(b)(3) (1986) (appended to I.R.C. § 1465, repealed by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(156), 90 Stat. 1520, 1789 (1976)); Rev. Rul. 72-173, 1972-1 C.B. 282.

316. Rev. Rul. 70-468, 1970-2 C.B. 171; Rev. Rul. 69-655, 1969-2 C.B. 168.

b. *Reliance on Advice of Counsel*

Although withholding is eliminated in many transactions as the result of an opinion of counsel, lawyers are not liable to withholding agents for wrong advice unless there has been a failure to exercise due care. Accordingly, this defense will fail as to both withholding and interest. Penalties, however, may be avoided as a result of reliance on professional advice.[317]

c. *Reliance on Statements of the Foreign Payee*

While it is virtually certain that actual knowledge of falsity would vitiate any defense, and that some duty of reasonable inquiry is required, there exist various verbal formulae in the regulations, under the Code, and under various tax treaties which, under certain circumstances, protect the withholding agent who has relied on statements of the foreign payee. Thus, a withholding agent may rely on the payee's statement of United States residence.[318] A withholding agent may also rely on the payee's statement that income is effectively connected income.[319] Nevertheless, no form can affect the withholding agent's duty to withhold on compensation for personal services.[320] A withholding agent may rely on a payee's claim of treaty benefits.[321] Although the regulations themselves contain no language protecting the withholding agent in this circumstance, a ruling has found such protection "implicit," absent actual knowledge of falsity.[322] A withholding agent may rely on a payee's calculation of gain in the case of payments only partially subject to withholding, such as certain gain on disposition of timber, and withholding on original issue discount pursuant to proposed regulations.[323] Anomalous is the fact that the regulations authorize a withholding agent to rely on the address of a payee for dividends,[324] although there is no parallel

317. Coldwater Seafood Corp. v. Commissioner, 69 T.C. 966 (1978) (accountant's advice) (appeal to 2d Cir. dismissed by stipulation on Oct. 20, 1978); Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971).

318. Treas. Reg. § 1.1441-5(a) (1986) (operative language: "may be relied upon"); Form 1078 prescribed but not mandated.

319. Treas. Reg. § 1.1441-4(a)(2) (1986) (operative language: "shall constitute authorization"); Form 4224 prescribed but not mandated.

320. Rev. Rul. 73-107, 1973-1 C.B. 376; Rev. Rul. 70-543, 1970-2 C.B. 172.

321. Treas. Reg. § 1.1441-6(c)(1); Form 1001 mandated.

322. Rev. Rul. 76-224, 1976-1 C.B. 268 (operative language: "is not responsible"); *see also* Rev. Rul. 70-175, 1970-1 C.B. 183, *superceding* I.T. 1529, I-2 C.B. 168 (1922).

323. Treas. Reg. § 1.1441-3(d)(2) (1986); Prop. Treas. Reg. § 1.1441-3(c)(6)(iii), 41 Fed. Reg. 28,517, 28,522 (1976) (operative language: "may, unless he has reason to believe to the contrary, rely on").

324. Treas. Reg. § 1.1441-3(b)(3) (1986).

provision for interest. The degree to which a withholding agent may rely on forms which are not filed in exactly the correct form, is an open question.[325]

d. *Statute of Limitations*

If there has been no withholding and no return is filed, the statute of limitations will never begin to run.[326] Once a return has been filed, however, if proper disclosure has been made of the facts which would enable the Service to determine whether withholding was required, a three-year statute of limitation should begin to run.[327] This indicates the desirability of filing a return even if the withholding agent claims that no withholding is necessary.

In considering the rights and liabilities of the withholding agent against the payee, only three cases have dealt with the situation where the withholding agent under-withheld, was assessed by the United States, and made payment. The agent sought to recover against the payee either by attempting to recoup or by withholding in respect of prior payments on subsequent distributions to the payee. Each of these three cases involved royalty payments payable to German residents just prior to the World Wars, giving rise to subsequent litigation with the Alien Property Custodian. In each case the court left the parties where it found them.

In *Synthetic Patents Co. v. Sutherland*,[328] the plaintiff corporation under-withheld on royalty payments to its German shareholders. The Alien Property Custodian seized the shares and sold them to a new purchaser, who had the corporation pay the past due withholding taxes and seek reimbursement from the Alien Property Custodian out of assets left by the German shareholders. The District Court allowed the recovery. The Circuit Court, however, reversed, holding that in view of its admitted failure to comply with the statute, the under-withholding withholding agent could not recover from its creditor.[329]

In *McGrath v. Dravo Corp.*,[330] the withholding agent made royalty payments without withholding. It then paid past-due taxes pursuant to assessment, and debited the amount of the tax to the nonresident alien's

325. For example, a form supplied after the fact of a payment without withholding.

326. I.R.C. § 6501(c)(3); Chared Corp. v. United States, 69-2 U.S. Tax Cas. (CCH) ¶ 9535 (N.D. Tex. 1969), *aff'd* 446 F.2d 745 (5th Cir. 1971), *rev'd on other grounds,* 455 F.2d 928 (5th Cir. 1972).

327. I.R.C. § 6501(e)(1)(A)(ii) (1986); Treas. Reg. § 301.6501(e)-1(a)(1)(ii) (1986).

328. 22 F.2d 491 (2d Cir. 1927), *cert. denied,* 276 U.S. 630 (1928).

329. *Id.* at 493-94.

330. 183 F.2d 709 (3d Cir. 1950).

funds remaining on deposit with the withholding agent. The Third Circuit held that the withholding agent could offset taxes paid against the fund in its possession owing to the nonresident alien under the theory of unjust enrichment.[331] The court distinguished *Synthetic Patents* on the ground that in *Synthetic Patents*, the withholding agent had allowed the nonresident alien's property to pass from its hands entirely.[332]

In *A. Gusmer, Inc. v. McGrath*,[333] the withholding agent again failed to withhold on amounts paid to a foreign person. It then paid the tax due, and filed an ultimately unsuccessful claim for the amounts paid against assets which had already been remitted to the Alien Property Custodian.[334] The circuit court affirmed the district court's dismissal of the withholding agent's petition on the ground that the withholding agent's failure to withhold was the source of its own problem.[335]

The net result of these cases appears to be that a withholding agent can reimburse himself for taxes paid due to under-withholding if funds still remain on hand, but that once the funds have been paid out to the foreign person, such reimbursement is no longer possible. Where affirmative recovery is sought for taxes which the withholding agent failed to withhold, the agent has to overcome such obstacles as public policy arguments;[336] the "penal" nature of tax claims, which are not cognizable under normal conflict-of-law principles;[337] and collateral costs of bringing actions outside the United States. Perhaps a withholding agent might obtain protection against under-withholding by pledge, letter of credit to be drawn on by the agent's affidavit, or some other security device.

It is arguable that any additional payments made by an under-withholding withholding agent are themselves subject to withholding, thus creating an infinite pyramid.[338] While no certain answer can be given as

331. *Id.* at 712-13.

332. *Id.* at 713.

333. 196 F.2d 860 (D.C. Cir. 1952), *aff'g* 94 F. Supp. 724 (D.D.C. 1950), *cert. denied,* 344 U.S. 831 (1952).

334. 196 F.2d at 862.

335. *Id.*

336. Neckles v. United States, 579 F.2d 938 (5th Cir. 1978) (one of three capitalizers of company, though not an officer, held solely liable for withholding as responsible person); Cantlon v. Ernce, 76-1 U.S. Tax Cas. ¶ 9362 (N.D. Tex. 1975) (no contribution among officers who fail to withhold on an employee's wages, when one officer was assessed for entire "penalty" of 100%).

337. Her Majesty the Queen in Right of the Province of British Columbia v. Gilbertson, 597 F.2d 1161 (9th Cir. 1979) (Canadian tax judgment denied enforcement in the United States); United States v. Harden, 41 D.L.R.2d 721 (Can. 1963) (United States tax judgment denied enforcement in Canada).

338. Safe Harbor Water Power Corp. v. United States, 303 F.2d 928 (Ct. Cl. 1962); Rev. Rul. 79-49, 1979-1 C.B. 58; Rev. Rul. 74-75, 1974-1 C.B. 19. I.R.C. section 6313 ends the

to the character of the extra tax payment, one possibility is that its character is the same as the payment to which it relates. Thus, an extra payment in respect of under-withholding of interest would be considered interest, an extra payment in respect of under-withholding on dividends would be considered a dividend, and so on. An alternative possibility is that, in spite of section 1461, the withholding agent is really secondarily liable. The tax consequences of the additional payment to the withholding agent, therefore, would be deferred until the "subrogation" claim became worthless, as in a bad debt situation. It is interesting to note that international finance subsidiary indentures generally plan for future characterization, in that they require extra payment of withholding to be treated as additional interest in order to preserve the net return to the investor.

The tax treatment of over-withholding is also uncertain. A deduction for extra payments may not be allowed where the effect would be to encourage violation of the law in contravention of public policy.[339] In addition, an extra payment may be denied deductibility under section 275(a)(1).

The principal defense of the overwithholding withholding agent is the indemnification found in section 1461, which provides that a withholding agent "is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter."[340] There is absolutely no explanation as to the nature of this indemnity. If the indemnity is limited to "payments made in accordance with the provisions of this chapter," however, it will, perforce, not cover over-withholding and hence will provide no protection.

A collateral question is whether the indemnity, if by some chance it

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pyramid, however, where less than one-half cent is involved. The so-called infinite pyramid can be finitely computed by using the following formula (where "a" is the first payment and "r" is the tax rate expressed as a decimal):

$$S = \frac{a}{1-r}$$

339. *Compare* Rev. Rul. 77-126, 1977-1 C.B. 47 (no deduction for loss of gaming devices) *and* Rev. Rul. 77-244, 1977-2 C.B. 58 (cost of goods sold may not be increased by Section 16(c)(2) payments) *with* Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477 (1977), *aff'd,* 630 F.2d 670 (9th Cir. 1980) (contra to ruling). *Sobel,* however, might be distinguishable on the ground that the underlying illegality was a violation of California laws establishing a minimum sale price for liquor, and those laws were later found to be in violation of the Sherman Act. *See* Rice v. Alcoholic Beverage Control Appeals Bd., 21 Cal. 3d 431, 579 P.2d 476, 146 Cal. Rptr. 585 (1978). *Cf.* Alex v. Commissioner, 70 T.C. 322 (1978).

340. I.R.C. § 1461 (1986).

is effective, will cover any amounts other than the tax, such as counsel fees, expenses, consequential damages, and interest in the case of a voluntary, but late payment. Further, it is not certain whether the indemnity is invoked by impleader or other procedural device. It can only be hoped that the courts will recognize that the public policy of the section 1461 indemnity provision will only be served if its applicability is construed broadly.

Assuming that the withholding agent cannot prove that the withholding was proper, the agent might argue that the payee's proper remedy is against the United States. In *DuPont Glore Forgan, Inc. v. American Telephone and Telegraph, Co.*,[341] both a claim for wrongful withholding of excise taxes, and the withholding agent's third party claim against the United States were dismissed on the ground that the plaintiffs had to pursue their remedies directly and exclusively against the government. The Chapter 3 statute, however, is different and indeed appears to contemplate third party action against a withholding agent; otherwise, the section 1461 indemnity provision would be nugatory.

If the overpaid tax is not actually withheld and the withholding agent makes a payment to the United States over and above the amount due, the withholding agent may always claim a refund.[342] If the overpaid tax was actually withheld prior to filing Form 1042, the withholding agent may either credit the overpayment against other withholding required on subsequent payments to the same payee within the same time frame,[343] or actually repay the excess to the payee,[344] in which case the withholding agent may also use the over-withheld amount as a credit against its withholding obligations during the next calendar year.[345] The withholding agent, however, may *not* claim a refund.[346] If the tax was overpaid, was not actually withheld, and was not promptly corrected, a refund is available within statutory limits.[347] Otherwise, if the withholding agent realizes his error after the time for filing his annual Chapter 3 return for the calendar year, there is no remedy for the withholding agent.[348] This is true even where the withholding agent repays the

341. 428 F. Supp. 1297 (S.D.N.Y. 1977).

342. I.R.C. § 1464 (1986); Treas. Reg. § 1.1464-1(a) (1986); I.R.C. § 6414 (1986); Treas. Reg. § 1.6414-1 (1986).

343. Treas. Reg. § 1.1461-4(a)(2) (1986).

344. Treas. Reg. § 1.1461-4(a)(1) (1986).

345. Treas. Reg. § 1.1461-4(b) (1986).

346. Treas. Reg. § 1.1464-1(9) (1986).

347. I.R.C. §§ 1464, 6414 (1986).

348. Capital Estates, Inc. v. Commissioner, 138 F.2d 156 (3d Cir. 1943); Bank of America v. Anglim, 138 F.2d 7 (9th Cir. 1943).

payee,[349] because the taxpayer is the proper party to claim a refund.[350]

4. Procedures and Forms

The withholding agent is required to make a deposit within fifteen days after the end of each calendar month during which the amount of undeposited tax withheld is $200 or more.[351] This requirement shall not apply if the withholding agent makes deposits four times a month when the amount of undeposited tax withheld from the start of any given calendar month to the end of such quarter-monthly period is $2000 or more.[352] Where no deposits are required under the foregoing rules, annual deposits are required by March 15 of any amounts withheld during the prior calendar year.[353]

Deposits of tax must be accompanied by Form 512.[354] The remittance may be sent either to a Federal Reserve bank or an authorized commercial bank depository. Form 512 must be requested by the withholding agent who must also furnish his "identification number." Thus, a withholding agent who does not have an identification number may not obtain a form, and will not be excused for failure to deposit.[355] Perhaps in these cases, the withholding agent ought to make payments to the Office of International Operations, together with a letter requesting both an identification number and Form 512, until such time as both are delivered. The annual payment, if any, may accompany Form 1042 and can be mailed to the Office of International Operations at the option of the withholding agent.[356] Form 1042S must also be filed annually,[357] and duplicate copies must be delivered to foreign authorities with which the United States has a treaty providing for exchange of data. Other required forms may include: Form W-2; Form 1099 (MISC), for compensation to independent contractors; and Form 1096, which accompanies Form 1099. Payees will, where applicable, file Form 1001 to claim treaty benefits,[358] Form 4224 to claim "effectively connected" status for a given class of income other than personal service income,[359] and Form 1078 to

349. Treas. Reg. § 1.6414-1(c); Rev. Rul. 61-207, 1961-2 C.B. 139.
350. Treas. Reg. § 1.1464-1(a); Ciba Pharmaceutical Products Inc. v. Commissioner, 35 T.C. 337, 355 (1960), *rev'd on other grounds* 297 F.2d 77 (3d Cir. 1961).
351. Treas. Reg. § 1.6302-2(a)(1)(i) (1986).
352. Treas. Reg. § 1.6302-2(a)(1)(ii) (1986).
353. Treas. Reg. § 1.6302-2(a)(1)(iv) (1986).
354. Treas. Reg. § 1.6302-2(b)(1)(ii) (1986).
355. Treas. Reg. § 1.6302-2(c) (1986).
356. Treas. Reg. §§ 1.6302-2(a)(1)(iv), 1.1461-3(a)(2) (1986).
357. Treas. Reg. § 1.1461-2(c) (1986).
358. Treas. Reg. § 1.1441-6 (1986).
359. Treas. Reg. § 1.1441-4(a) (1986).

claim residency status.[360]

C. USRPI Withholding

1. General Rule

As a result of DEFRA, a transferee of a USRPI is now generally required to deduct and withhold a tax equal to ten percent of the amount realized on all post-1984 dispositions of USRPIs.[361] No later than ten days after the transfer, the transferee is required to file Forms 8288 and 8288-A with the Internal Revenue Service in Philadelphia. The IRS will stamp and mail Form 8288-A to the transferor.[362] An agent may, under certain circumstances,[363] succeed to the withholding obligation of the transferee, but only to the extent of the agent's compensation derived from the transaction.[364]

2. Definitions

The following defined terms are helpful in understanding Section 1445 as it relates to USRPI withholding:

Amount Realized — the sum of cash paid or to be paid; the fair market value of other property transferred or to be transferred; and the outstanding amount of any liability assumed by the transferee to which a USRPI is subject immediately before and after the transfer.[365]

Transferor — the person disposing of a USRPI.[366]

Transferee — the person acquiring the USRPI.[367]

Transferor's agent — any person who represents the transferor in any negotiation with the transferee or the transfereer's agent, or in settling the transaction.[368]

Transferee's agent — any person who represents the transferee in any negotiation with the transferor or the transferor's agent, or in settling the transaction.[369]

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360. Treas. Reg. § 1.1441-5(a) (1986).

361. I.R.C. § 1445(a) (1986). A ten percent withholding rate was selected because the House and Senate conferees agreed that in most cases, a ten percent rate would approximate the amount of net tax owed by most foreign transferors on the disposition of a USRPI. No withholding applies to payments with respect to dispositions taking place prior to January 1, 1985.

362. Treas. Reg. § 1.1445-1(c) (1986).

363. *See infra* notes 418-423 and accompanying text.

364. I.R.C. § 1445(d)(2)(B) (1986).

365. Treas. Reg. § 1.1445-1(g)(5) (1986).

366. I.R.C. § 1445(f)(1) (1986).

367. I.R.C. § 1445(f)(2) (1986).

368. I.R.C. § 1445(d)(3) (1986).

369. I.R.C. § 1445(d)(4) (1986).

Settlement officer — one who merely receives or disburses consideration and/or records a document, and who will, therefore, not be considered an agent.[370]

Transferor's maximum liability — in the case of an individual transferor, the transferor's maximum liability, as defined by section 871(b)(1), is the contract price less the adjusted basis. In the case of a corporate transferor, the transferor's maximum liability, as defined by section 882(a)(1), is the contract price less the adjusted basis multiplied by the maximum capital gain rate, subject to adjustments such as treaty rate reductions, nonrecognition provisions, losses on USRPIs previously disposed of, and recapture items. In both cases, the transferor's unsatisfied withholding liability is added to these amounts.[371]

Transferor's unsatisfied withholding liability — the extent to which the withholding obligation imposed by new section 1445, either on the transferor's acquisition of a USRPI or on the acquisition of a predecessor interest, has not been satisfied.[372]

3. Special Rules

a. *Distributions by USRPHCs to Foreign Shareholders*

Under the provisions of section 1445(e)(3), a domestic corporation that is or was a USRPHC during the shorter of the period after June 18, 1980 or the five-year period ending with the disposition of the interest in the USRPHC,[373] must deduct and withhold a ten percent tax on the amount realized by a foreign shareholder from: (1) any distribution in respect of either a redemption of all or part of the stock in the USRPHC; (2) a liquidation, whether complete or partial, of the USRPHC or any subsidiary; or (3) a deemed sale or exchange of the USRPHC stock to the extent that the USRPHC is a collapsible corporation.[374]

With respect to liquidating distributions of non-USRPIs by a domestic corporation which has not elected section 337 treatment, a qualifying statement[375] may be requested on the ground that the foreign shareholder's surrender of his interest in the corporation may not be subject to tax under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[376] The rationale for this position is that where the corporation has not elected section 337 treatment, tax will have been paid at

370. I.R.C. § 1445(d)(5) (1986).
371. I.R.C. § 1445(f)(4) (1986); Treas. Reg. § 1.1445-3(c)(ii) (1986).
372. I.R.C. § 1445(f)(5) (1986).
373. *See* I.R.C. § 897(c)(1)(A)(ii) (1986).
374. I.R.C. § 1445(e)(3) (1986).
375. *See infra* notes 416-17 and accompanying text.
376. Pub. L. No. 96-499, 94 Stat. 2682 (1980).

the corporate level. Section 897(c)(1)(B) excludes from the definition of a USRPI an interest in a corporation not currently holding USRPIs and that was taxed at the corporate level on previous distributions of such interests. TRA 86 specifically amends section 1445(e)(3) to exempt from withholding a distribution of any interest in a corporation that is not a USRPI by virtue of section 897(c)(1)(B).[377]

Where the Code accords nonrecognition treatment to the foreign distributee of a USRPI distributed in liquidation of a domestic corporation, and where this nonrecognition treatment is not overridden by section 897(e), a qualifying statement may also be required to exempt the domestic corporation from withholding.[378] The repeal of the *General Utilities* doctrine by TRA 86, however, will likely preclude issuance of qualifying statements for post-1986 liquidations.

b. *Distributions by Foreign Corporations*

A foreign corporation must deduct and withhold a thirty-four percent tax on the amount of gain recognized in any distribution subject to tax under sections 897(d) and (e).[379] The congressional conferees associated with TRA 86 intended that even a foreign corporation which had elected under section 897(i) to be treated as a domestic corporation for substantive and reporting provisions would also be treated as a domestic corporation for withholding purposes.[380] Because a foreign corporation making a section 897(i) election could elect tax-free treatment of a liquidation-related sale, the conferees intended that a tax withheld on such a sale be offset by a credit, to be implemented by the regulations.[381] Moreover, the conferees felt that if the section 897(i) election were applicable to withholding, an electing foreign corporation could provide a non-foreign certification, which would be confusing.[382] The temporary regulations, which have since been issued, however, specify when such a certification is valid as the result of a section 897(i) election by requiring the transferor to attach a copy of the section 897(i) election that the IRS has acknowledged.[383]

377. Pub. L. No. 99-514, § 1810(f)(5), 100 Stat. 2085, 2827-28 (1986).

378. I.R.C. § 1445(e)(2) (1986). *See also infra* notes 418-24 and accompanying text.

379. I.R.C. § 1445(e)(2) (1986).

380. *See generally* CONF. REP. No. 841, *supra* note 176, at II-841.

381. *Id.*

382. *Id.*

383. Treas. Reg. §§ 1.1445-2(b)(2)(ii), 1.1445-5(b)(3)(ii)(C), and 1.1445-7(a) (1986).

c. *Distributions by Noncorporate Entities*

Prior to TRA 86, a domestic partnership, the trustee of a domestic trust, and the executor of a domestic estate had to deduct and withhold a ten percent tax on any amount under the custody of any such entity which is attributable to the disposition of a USRPI by the entity and is includible in the income of either a foreign partner of the partnership, a foreign beneficiary of the trust or estate, or a foreign person who is treated as the owner of the trust under section 671.[384] TRA 86, however, provides that domestic partnerships, estates, and trusts must withhold on distributions of USRPIs at the rate of thirty-four percent of the gain realized, to the extent that the gain is taken into account by, or allocable to, a foreign beneficiary or foreign partner.[385] Apparently, it is deemed feasible to withhold on the basis of gain in this circumstance because the transferor's fiduciary will have some notion of the transferor's basis in the distributed interest. The thirty-four percent rate, however, assumes that all partners and beneficiaries are corporations, which appears to be unjustified.

In addition, a domestic or foreign partnership, the trustee of a domestic or foreign trust, and the executor of a domestic or foreign estate must deduct and withhold a ten percent tax on the fair market value of the USRPI at the time of the distribution of a USRPI to a foreign partner or beneficiary in exchange for all or a part of his interest in the entity, as provided by section 897(g).[386] TRA 86 amended section 1445(e)(4) to omit the specific reference to distributions subject to tax pursuant to section 897(g), inasmuch as such distributions may also be subject to tax pursuant to section 897(e)(2)(B) and should, therefore, be subject to withholding as well.[387]

d. *Transferees of Noncorporate Entity Interests*

The transferee of a partnership interest or a beneficial interest in a trust or estate must deduct and withhold a ten percent tax on the amount realized on the disposition of such interest.[388] Because regulations under sections 897(e)(2) and 897(g) have not yet been promulgated to define when a distribution of an interest in a noncorporate entity may be taxable, withholding on the distribution of such interest will be postponed

384. I.R.C. § 1445(e)(1) (1985).
385. I.R.C. § 1445(e)(1) (1986).
386. I.R.C. § 1445(e)(4) (1985).
387. I.R.C. § 1445(e)(4) (1986).
388. I.R.C. § 1445(e)(5) (1986).

until the regulations become effective.[389]

e. *Coordination with Nonrecognition Provisions*

No withholding is required if: (1) the transferor notifies the transferee that by virtue of a Code or treaty provision, the transferor is not required to recognize gain or loss on the transfer; and (2) the transferee forwards the notice of nonrecognition treatment to the Internal Revenue Service in Washington, D.C. within ten days of the transfer.[390] No specific form is required for a notice of nonrecognition treatment, but it must be verified under penalty of perjury, and must contain transactional information and a summary of the law and the facts supporting nonrecognition.[391] A notice of nonrecognition treatment may not be relied upon where not all of the gain is subject to nonrecognition treatment and where the transferee knows or has reason to know that the transferor is not entitled to nonrecognition treatment.[392]

f. *Special Foreclosure Rules*

A transferee acquiring a USRPI through repossession or foreclosure under a mortgage, security agreement, deed of trust, or the like may withhold the lesser of ten percent of the amount realized by the transferor/debtor on the transfer, or the excess of the amount realized by the transferor/debtor over the debts secured by the property at the time of foreclosure.[393] A transferee of a USRPI pursuant to a deed in lieu of foreclosure must withhold a tax equal to ten percent of the amount realized by the transferor/debtor.[394] If, however, (1) the transferee is the only person with a security interest in the property, (2) no cash is generated, and (3) the notice requirements discussed below are complied with, withholding is not required.[395]

The transferee must file a notice with the Internal Revenue Service in Washington, D.C. by the twentieth day after the transfer, unless the transferee opts to use the special provisions for foreclosures, in which case notice must be given to the court or trustee on the day of foreclosure.[396] While no form is prescribed, the regulations set forth the re-

389. Treas. Reg. § 1.1445-5(b)(8)(v) (1986).
390. Treas. Reg. § 1.1445-2(d)(2)(i) (1986).
391. Treas. Reg. § 1.1445-2(d)(2)(iii) (1986).
392. Treas. Reg. § 1.1445-2(d)(2)(ii) (1986).
393. Treas. Reg. § 1.1445-2(d)(3)(i)(A) (1986).
394. Treas. Reg. § 1.1445-2(d)(3)(i)(B) (1986).
395. *Id.*
396. Treas. Reg. § 1.1445-2(d)(3)(ii), (iii) (1986).

quirements for the notice, including the amount of the debt and the fair market value of the property.[397]

The transferee may not rely on the foreclosure rules if a principal purpose of the transaction was to avoid section 1445(a) withholding.[398] Existence of a purpose to avoid section 1445(a) withholding is rebuttably presumed if the transferee acquires property in which the transferee or a related party had a security interest; the security agreement did not arise in connection with the acquisition, improvement, or maintenance of the property; and the total amount of all debts secured by the property exceeds ninety percent of its fair market value.[399]

g. *Real Estate Investment Trusts (REIT)*

When an REIT, or any partnership or trust whose interests are traded on an established securities market, distributes an amount attributable to the disposition of a USRPI to a foreign person, the REIT, partnership, or trust must withhold thirty-four percent of a post-1986 distribution.[400] If the distribution is before 1987, twenty-eight percent must be withheld in the case of REITs, and similar amounts are withheld in the case of partnerships and trusts as determined under Treasury Regulation section 1.1445-5(c)(3).[401]

Special rules apply to partnerships or trusts with more than 100 partners or beneficiaries, but whose interests are not traded on an established securities market.[402] These entities are required to withhold thirty-four percent of the gain realized from each distribution to a foreign person relating to the disposition of a USRPI. The amount withheld, however, is twenty-eight percent for distributions occurring after November 21, 1986 for partnership or trust taxable years beginning before January 1, 1987.[403]

4. Exemptions

A certification of a transferor may be furnished by the transferor to the transferee certifying the transferor's nonforeign status.[404] It must state under penalty of perjury that the transferor is not a foreign person

397. Treas. Reg. § 1.1445-2(d)(3)(iii) (1986).
398. Treas. Reg. § 1.1445-2(d)(3)(v) (1986).
399. *Id.*
400. I.R.C. § 1445(e)(1) (1986).
401. Temp. Treas. Reg. § 1.1445-8T(c)(1), (2) (1986).
402. Treas. Reg. § 1.1445-5(c)(3) (1986).
403. Treas. Reg. § 1.1445-5(c)(3)(ii) (1986).
404. Treas. Reg. § 1.1445-2(b)(2) (1986).

and provide the transferor's name, taxpayer identification number, and office address, or home address in the case of an individual. No particular form is prescribed for the certification, and there is no implication that the certification must be sworn out before a notary—an issue which was of great concern to many foreign investors. Nonmandatory sample certification forms which the IRS will accept are set forth at Treasury Regulation section 1.1445-2(b)(2)(iii)(A) and (B). The transferee must retain the certification until the end of the fifth year following the taxable year in which the transfer takes place.[405] A foreign corporation that has made an election under section 897(i) may furnish the certification if it attaches a copy of the Internal Revenue Service's acknowledgment of the election under Treasury Regulation section 1.897-3(d)(4). This exemption is subject, however, to an exception.[406]

A nonforeign certification of a nonpublic domestic corporation will exempt from withholding the transfer of any interest in a nonpublic domestic corporation.[407] This certification may be furnished by a corporation to the transferee. It must state under penalty of perjury either that the corporation was not a USRPHC for the previous five years, or that interests in the corporation are not USRPIs because either (1) the corporation did not hold any USRPIs, or (2) the USRPIs held by the corporation were disposed of in a transaction in which the full amount of gain was recognized.[408] No particular form is required, and there is no implication that certification must be sworn out before a notary. Acceptable sample certifications, as stated above, are set forth in Treasury Regulation section 1.1445-2(b)(2)(iii)(A) and (B). The retention requirements and the provisions regarding coordination with the section 897(i) election applicable to the noncorporate certification apply here as well. Well-advised purchasers of stock in any domestic nonpublic corporation will seek such a certification and supporting warranties in the purchase agreement.

The foregoing certification exemptions do not apply if the transferee has knowledge that a certification is false, whether such knowledge is actual or constructive, by virtue of a notice of false certification issued pursuant to section 1445(d)(1) by an agent of either the transferor or transferee.[409] The agent who furnishes this notice, however, must have actual knowledge of the false certification. In the case of a foreign corpo-

405. Treas. Reg. § 1.1445-2(b)(3) (1986).
406. *See infra* notes 409-15 and accompanying text.
407. I.R.C. § 1445(b)(3) (1986).
408. I.R.C. § 897(c)(1)(B) (1986).
409. I.R.C. § 1445(b)(7) (1986).

rate transferor, its agent will be deemed to have actual knowledge that any nonforeign affidavit is false.[410]

The notice of false certification must be filed with the transferee as soon as possible if the transfer has not yet occurred. If the transfer has occurred, the agent must file the notice within three days of learning that the certification was false.[411] Although no form of notice of false certification is required, the regulations set forth an acceptable sample, and direct that a copy of the notice be sent to the Internal Revenue Service.[412] Failure to furnish the notice of false certification as specified by the regulations will result in the imposition of direct liability for withholding on the agent, but only to the extent of his compensation derived from the transaction.[413]

A transferee is still entitled to rely on a nonforeign certification for payments made prior to delivery of a notice of its falseness. The transferee, however, must thereafter withhold ten percent of the amount realized, if possible, by withholding and paying over the full amount of any payments made until ten percent of the amount realized has been paid.[414] Each such payment to the IRS for withholding must be made by the tenth day after each payment to the transferor is made.[415]

A "qualifying statement" is a statement by the Secretary of the Treasury that the transferor either (1) has reached agreement with either the Secretary or the transferee that the transferor's tax on the gain from the disposition of the USRPI will be paid; or (2) is exempt from such tax. Additionally, the qualifying statement evidences any unsatisfied withholding tax liability of the transferor that has either been satisfied or adequately secured.[416] This provision applies where the transferee receives a qualifying statement from the Secretary which takes the form of a withholding certificate applied for by either the transferor or the transferee.[417]

If the certificate is obtained prior to a transfer, it notifies the transferee that the withholding is to be reduced, eliminated, or made on the special basis provided therein. If the certificate is obtained after the transfer, it authorizes a normal or early refund.[418] If the application for a withholding certificate is pending on the date of the transfer, the trans-

410. *See* Treas. Reg. § 1.1445-4(a)(2) (1986).
411. Treas. Reg. § 1.1445-4(c)(1) (1986).
412. *Id.*
413. I.R.C. § 1445(d)(2) (1986); Treas. Reg. § 1.1445-4(e) (1986).
414. Treas. Reg. § 1.1445-2(b)(4)(iv) (1986); *cf.* Treas. Reg. § 1.1445-4(d) (1986).
415. Treas. Reg. § 1.1445-2(b)(4)(iv) (1986).
416. I.R.C. § 1445(b)(4)(ii) (1986).
417. *See generally* Treas. Reg. § 1.1445-3 (1986).
418. Treas. Reg. § 1.1445-3(a), (g) (1986).

feree is nevertheless obligated to withhold.[419] Prudence dictates a withholding escrow, because the transferee would fund his secondary liability securely and the transferor would be assured a speedy refund of any excess liability.

A request for a qualifying statement or withholding certificate will be acted upon by the Secretary within ninety days after receipt.[420] Applications have no mandated form, but must contain the identification of the parties to the transaction, as set forth in Treasury Regulation section 1.1445-3(b)(1)-(3).[421]

There are some important reasons for the foreign investor to apply for a withholding certificate. First is the consideration of the appropriateness of reduced withholding, in which case the application must include calculations of the maximum tax on the disposition, calculated in accordance with Treasury Regulation section 1.1445-3(c)(2); the transferor's unsatisfied withholding liability, calculated in accordance with Treasury Regulation section 1.1445-3(c)(3); and in the case of a request for a special reduction of tax, a statement of the relevant law and facts. A second reason for applying is to receive an exemption from United States tax based on a claim under either section 892, or an income tax treaty not made inapplicable after December 31, 1984 by FIRPTA. Also, a certificate may be part of a special agreement for payment not only of tax, but also interest thereon, and the transferor's maximum tax liability, as determined under Treasury Regulation section 1.1445-3(c), plus a twenty- five percent surcharge securing interest and penalties.[422] Additionally, the agreement must provide security acceptable to the Internal Revenue Service, which would include: (1) a surety bond of a United States surety, bank, or insurance company;[423] (2) a bond secured by either United States government securities or a certified check drawn on a bank acceptable to the Service;[424] and (3) a letter of credit issued by a bank acceptable to the Internal Revenue Service.[425]

A transferee who defers withholding in reliance on an application for a withholding certificate made with the principal purpose of delaying payment is liable for interest and penalties. The existence of a purpose to delay payment is rebuttably presumed if the transferee applied for a with-

419. *Id.*
420. I.R.C. § 1445(c)(3)(B) (1986).
421. *See, e.g.*, Rev. Proc. 85-41, 1985-2 C.B. 482-96.
422. Treas. Reg. § 1.1445-3(e)(2)(iii) (1986).
423. Treas. Reg. § 1.1445-3(e)(3)(ii) (1986).
424. Treas. Reg. § 1.1445-3(e)(3)(iii) (1986).
425. Treas. Reg. § 1.1445-3(e)(3)(iv) (1986).

holding certificate based on the transferor's maximum tax liability and the liability is ultimately determined to be ninety percent or more of the amount otherwise required to be withheld and paid over.[426]

Another exemption applies where the amount realized by the transferor of a USRPI is less than $300,000 and where the property is acquired by the transferee for use as his or her own residence.[427] The regulations, however, provide that the subject property will be considered as the transferee's residence only if he or she has definite plans to reside there for at least fifty percent of the number of days that the property is in use during the two twelve-month periods following the date of purchase.[428]

The exemption for acquiring traded stock applies to transfers of a class of stock regularly traded on an established securities market.[429] The foreign investor should be aware that the securities market in question need not be a domestic securities market.[430]

5. Reporting

Reporting will continue to be required of foreign persons holding direct investments in USRPIs for the calendar year if: (1) those foreign persons are not engaged in a trade or business in the United States during the calendar year; and (2) the fair market value of the subject property equals or exceeds $50,000.[431] Attribution rules provide that interests held by partnerships, estates, and trusts are treated as being owned proportionately by their partners and beneficiaries. In addition, interests held by the spouse or minor child of an individual are treated as being owned by such individual.[432]

A return must be filed at the time and in the manner required by regulations yet to be issued, setting forth: (1) the name and address of the foreign person holding the direct investment in the USRPI; (2) a description of all USRPIs held by such person at any time during the calendar year; and (3) such other information as the Secretary shall prescribe by regulations.[433]

426. Treas. Reg. § 1.1445-1(c)(2)(ii)(B) (1986).
427. I.R.C. § 1445(b)(5) (1986).
428. Treas. Reg. § 1.1445-2(d)(1) (1986).
429. I.R.C. § 1445(b)(6) (1986).
430. *See id.*
431. I.R.C. § 6039C(b) (1986).
432. I.R.C. § 6039C(c)(3)(B) (1986).
433. I.R.C. § 6039C(a) (1986).

6. Effective Dates

Withholding provisions generally apply to dispositions of USRPIs after January 1, 1985. The transfer of certain entity interests, however, is not subject to withholding until the effectiveness of regulations dealing with their taxability under FIRPTA is determined. Reporting provisions apply to calendar years beginning in 1980.[434]

D. Partnership Withholding

1. General Rule

Section 1446, added by TRA 86, provides that if any partnership, domestic or foreign, has any income, gain, or loss which either is or is treated as effectively connected with the conduct of a trade or business within the United States, then anyone who is a withholding agent under section 1441(a) must withhold a tax equal to twenty percent of post-1987 distributions to non-United States partners.[435]

2. Non-Effectively Connected Partnerships

If the partnership's gross income for the three years preceding the distribution either is or is treated as less than eighty percent effectively connected with the conduct of a trade or business within the United States, only that percentage which is effectively connected income is subject to withholding.[436]

3. Exceptions

No withholding is required under section 1446 if withholding is required under sections 1441 or 1442, or would be if a treaty did not lower or exempt the withholding.[437] In the case of a partnership substantially all of whose United States source income and effectively connected income is allocable under section 704 to United States persons, withholding under section 1446 will not apply.[438] Regulations will be promulgated to prevent duplicative withholding under sections 1445 and 1446.[439]

434. Pub. L. No. 96-499, § 1123(a), 94 Stat. 2599, 2687-88 (1980).
435. I.R.C. § 1446(a) (1986).
436. I.R.C. § 1446(b) (1986).
437. I.R.C. § 1446(c)(1) (1986).
438. I.R.C. § 1446(c)(2) (1986), as modified by the Technical Corrections Act of 1987, H.R. 2636, 100th Cong., 1st Sess. § 112(q)(1) (1987).
439. I.R.C. § 1446(c)(3) (1986).

4. Overwithholding

Withheld amounts in excess of the foreign partner's liability will be treated as overpayments of tax and thus subject to claims for refund.[440]

5. Regulations

Regulations will specify the proper withholding agent in the case of tiered partnerships and the appropriate withholding requirement in the case of a partnership that has effectively connected income for the first time.[441]

VI. PLANNING CONSIDERATIONS

A. Income Tax

With regard to income tax, a nonresident alien should accelerate or defer income to coincide with periods of nonresidence, taking into account the tax rate in the home country and any applicable treaty benefits. Similar timing techniques may be used regarding deductible expenses. There are collateral problems in connection with a change of residence, *e.g.*, the effect of a change of residence on the status of foreign corporations which are subject to indirect taxation under United States laws. The result is the possible imposition of an accumulated earnings tax or constructive dividend treatment of (1) the earnings and profits of a controlled foreign corporation, (2) the excess distributions of a passive foreign investment company, and (3) the undistributed foreign personal holding company income of a foreign personal holding company. Various penalty taxes on undistributed income of a foreign investment company or a personal holding company may also result. A change in the status of a foreign trust may trigger throwback rules, interest charges on accumulation distributions, and similar consequences.

B. Estate and Gift Tax

A nonresident alien may transfer tangible foreign situs property and intangible personal property with relative freedom from United States gift or estate tax, so long as the gift is completed outside the United States. Where the transfer is subject to the "string powers" of sections 2035-2038, however, subsequent events may make such gifts subject to tax. Similarly, by operation of the situs rules,[442] the arrival of a nonresi-

440. I.R.C. § 6401(b)(2) (1986).
441. CONF. REP. NO. 841, *supra* note 176, at II-654.
442. *See supra* notes 226-60 and accompanying text.

dent alien may result in the application of the unified estate and gift tax rules.

There is a substantial disincentive for nonresident aliens to make gifts, due principally to the differing unified credit and tax rate structures that apply. This disincentive is illustrated by the following example which contrasts the tax paid by nonresident aliens with two million dollars and four million dollars, respectively, of property subject to United States transfer taxes. The first set of computations demonstrates a gift of one-half of the transfer tax base, followed by an estate tax on the remaining half, with the tax cost of a transfer at death. The second set of computations demonstrates the tax paid where the nonresident alien makes no gift, and the entire transfer tax base is included in the taxable estate.

TRANSFER TAX BASE	$2,000,000		$4,000,000	
Gift of 1/2 the base	1,000,000		2,000,000	
Gift tax [§§ 2502(a), 2001(c)]	345,800		780,800	
Unified Credit [§ 2505 (a)]	0		0	
NRA Gift Tax		$345,800		$780,800
Tax base before gift	2,000,000		4,000,000	
Less gift	1,000,000		2,000,000	
Balance	1,000,000		2,000,000	
Less gift tax	345,000		780,800	
Taxable estate	654,200		1,219,200	
Estate tax [§ 2101(d)] on taxable estate plus adjusted taxable gift	301,008		749,760	
Less estate tax [§ 2101(d)] on adjusted taxable gifts	144,000		384,000	
Less unified credit [§ 2102(c)]	3,600		3,600	
NRA estate tax		153,408		362,160
Total NRA Transfer Tax		499,208		1,142,960
No Gift				
Taxable estate	2,000,000		4,000,000	
Tax [§ 2101(b), (d)]	384,000		984,000	
Less unified credit [§ 2102(c)]	3,600		3,600	
NRA estate tax		380,400		980,400
TAX SAVINGS		118,808		162,500

While in both cases, avoidance of a lifetime gift results in substantial tax savings, note that the variation in the amount of tax is geometrically

larger and the variation in the amount of savings is, correspondingly, geometrically smaller as the amount of the transfer tax base increases. The example also shows that lifetime transfers by a nonresident alien of property to which the gift tax applies are not desirable because such transfers are subject to the same tax rate as those applicable to citizens and residents. Any gift tax paid, however, is credited against the nonresident alien's estate tax only at the lower section 2101(d) rates. Additionally, since the tax applicable to a death transfer is less than the tax applicable to a lifetime transfer followed by a death transfer in the same total amount, minimization of the United States tax base is encouraged.

Acquisition of United States real or tangible personal property through a foreign corporation may convert the property into intangible property, namely, the stock of a foreign holding corporation. This will result in an exclusion from the nonresident alien's United States tax base for estate and gift tax purposes. Where the corporation is merely the custodian and not the beneficial owner of securities, such a transaction will not be recognized.[443] Because the shareholder is a nonresident alien, subpart F implications are presumably absent. Transfer of the shares free of income tax is possible if the transfer is made offshore in accordance with section 862(a)(6). The basis of the underlying real property, however, would not be stepped-up by virtue of the sale of stock. If United States real property owned by a nonresident alien is to be exchanged for stock of a foreign holding company, even with due observation of corporate formalities, gain would be recognized inasmuch as nonrecognition provisions, such as section 351, would not apply.[444] The careful planner will take into account the interrelationship of section 897(i) and nondiscrimination clauses in certain income tax treaties.

C. Generation-Skipping Transfer Tax

The possible applicability of the generation-skipping transfer tax enacted by TRA 86 should also be considered by the foreign investor. The tax is computed under section 2602, with reference to the taxable amount received by the transferee, as defined by section 2621. The computation is made on the basis of the maximum tax rate[445] applicable to domestic estates in all cases, regardless of the fact that the deemed transferor might be a nonresident alien whose estate would be subject to tax at the substantially lower section 2101(d) rates.[446] Because the gift tax base

443. Fillman v. United States, 355 F.2d 632 (Ct. Cl. 1966).
444. I.R.C. § 897(e)(1) (1986).
445. *See* I.R.C. § 2001(c) (1986).
446. *See supra* notes 75-89 and accompanying text.

provisions permit distribution of intangibles, it follows that the exchange of real property for shares of a domestic corporation, followed by an *inter vivos* distribution, might avoid a generation-skipping transfer tax if it survived attack under a "step transaction" or similar theory. In addition, because the section 2001(c) rates are higher than the section 2101(d) rates applicable to death transfers by nonresident aliens, it is possible that a testamentary general power of appointment will achieve the same dispositive intent as a generation-skipping transfer at a lower tax cost.

It is important to recall that bank deposits qualify as a foreign source under section 871(i)(2). This exception from the source rules is also available to nongrantor United States "conduit" trusts.[447]

Investments in "United States-connected" interest-bearing obligations would appear attractive to the nonresident alien investor. In this connection, note also the "80-20" rule as it survived in the final text of TRA 86. The portfolio interest exception of section 871(h) makes Eurobonds and similar investment vehicles attractive.

Great care should be exercised by the nonresident alien in creating a foreign trust, as mistakes can be costly.[448] By contrast, distributions to a United States beneficiary from a foreign estate are free of the accumulated throwback rules.[449]

VII. FORMS

A. Income Tax

A nonresident alien must file an income tax return on Form 1040NR if he or she is engaged in a trade or business in the United States. If a nonresident alien is married to a United States citizen or resident at the end of the tax year, he or she may elect to file a Form 1040 and be treated as a resident for that and all subsequent years, until the election is revoked.[450]

B. Estate Tax

The United States estate of a nonresident alien is returned on Form 706NA. The federal estate tax is computed in four steps: (1) determination of the entire gross estate wherever situated; (2) determination and itemization of the gross estate situated in the United States, in accord-

447. Isidro Martin-Montis Trust v. Commissioner, 75 T.C. 381 (1980); Rev. Rul. 82-193, 1982-2 C.B. 219; Rev. Rul. 81-244, 1981-2 C.B. 151.

448. *See, e.g.*, I.R.C. §§ 667(a)(3), 668, 679, and 1491 (1986).

449. Treas. Reg. § 1.665(a)-0A(d) (1986).

450. I.R.C. § 6013(g) (1986).

ance with the situs rules discussed above; (3) determination of authorized deductions which are entered on the return and subtracted from that part of the gross estate which is situated in the United States, thereby determining the taxable estate; and (4) computation of the tax and any allowable credit.[451] The return must be filed by the decedent's personal representative within nine months of the date of the decedent's death, absent an extension.[452] If the decedent does not have a personal representative in the United States, the return must be filed by *every* person in actual or constructive possession of *any* property of the decedent. The foreign investor should take into consideration the liability for estate and gift tax by transferees and fiduciaries.[453]

C. Gift Tax

After applying the situs rules,[454] gifts by a nonresident alien which are subject to United States gift tax are reportable on Form 709. As a result of ERTA, returns are due on an annual basis.[455]

VIII. CONCLUSION

Careful planning can make the United States a virtual tax haven for the foreign investor. The income tax rules generally encourage portfolio investment and subject real estate investment to no more onerous burdens than those borne by United States residents. The estate and gift tax regimens contain relatively unambiguous situs rules which lend themselves to investment planning. Given its political stability, the United States is, and should remain, an enticing environment for the investment of foreign capital.

451. *See generally* Treas. Reg. § 20.6018-3(b) (1986).
452. I.R.C. §§ 6018, 6075(a) (1986); Treas. Reg. § 20.6018-3(b) (1986).
453. I.R.C. §§ 6901-6905 (1986).
454. *See supra* notes 137-41 and accompanying text.
455. I.R.C. § 6075(b)(1) (1986).